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TRANSFORMING THE DEPARTMENT OF DEFENSE FINANCIAL MANAGEMENT: A STRATEGY FOR CHANGE

HEARING

BEFORE THE

SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS AND INTERNATIONAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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CONTENTS

Page

Hearing held on June 4, 2002 1

Statement of:

Friedman, Stephen, chairman, Department of Defense Financial Management Study Group, HE Marsh & McLennan Capital, Inc.; Lawrence J. Lanzillotta, Principal Deputy Under Secretary of Defense, Deputy Under Secretary Defense for Management Reform, Office of the Under Secretary of Defense, accompanied by Tina Jonas, Deputy Under Secretary of Defense for Financial Management, Office of the Under Secretary of Defense 7

Schmitz, Joseph E., Inspector General, accompanied by Robert Lieberman, Deputy Inspector General, Department of Defense; Gregory Kutz, Director, Financial Management and Assurance Team, accompanied by Randolph C. Hite, Director, Information Technology Systems Issues, U.S. General Accounting Office; and Franklin C. Spinney, Jr., Tactical Air Analyst, Department of Defense 52

Letters, statements, etc., submitted for the record by:

Friedman, Stephen, chairman, Department of Defense Financial Management Study Group, HE Marsh & McLennan Capital, Inc., prepared statement of 11

Kutz, Gregory, Director, Financial Management and Assurance Team, prepared statement of 68

Lanzillotta, Lawrence J., Principal Deputy Under Secretary of Defense, Deputy Under Secretary Defense for Management Reform, Office of the Under Secretary of Defense, prepared statement of 26

Lieberman, Robert, Deputy Inspector General, Department of Defense, prepared statement of 56

Shays, Hon. Christopher, a Representative in Congress from the State of Connecticut, prepared statement of 3

Spinney, Franklin C., Jr., Tactical Air Analyst, Department of Defense, prepared statement of 100

TRANSFORMING THE DEPARTMENT OF DEFENSE FINANCIAL MANAGEMENT: A STRATEGY FOR CHANGE

TUESDAY, JUNE 4, 2002

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS AND INTERNATIONAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2154, Rayburn House Office Building, Hon. Christopher Shays (chairman of the subcommittee) presiding.

Present: Representatives Shays, Schrock, Kucinich, and Tierney.

Staff present: Lawrence J. Halloran, staff director and counsel; J. Vincent Chase, chief investigator; Dr. R. Nicholas Palarino, senior policy advisor; Kristine McElroy and Thomas Costa, professional staff members; Sherrill Gardner, detailee, fellow; Jason M. Chung, clerk; David Rapallo, minority counsel; and Earley Green, minority assistant clerk.

Mr. SHAYS. Good morning. I apologize for keeping you all waiting. I like to start on time, so I do apologize. Last Friday, the Office of Management and Budget, OMB, transmitted the 2002 financial management report to Congress. According to that report, the largest impediment to removing the disclaimer from the governmentwide financial statements remains the Department of Defense DOD's serious financial management problems. These problems are pervasive, complex, longstanding and deeply rooted in virtually all business operations throughout the Department. More than 1 year ago, David Walker, the Comptroller General and head of the General Accounting Office, GAO, sounded a similar alarm. He told our subcommittee DOD suffered pervasive weakness in its financial management systems, operations and controls, including an inability to compile financial statements that comply with generally accepted accounting government accounting principles.

Today, at the urging of our ranking member, Mr. Kucinich, the subcommittee asks the Defense Department GAO, the DOD Inspector General, IG and others to describe current strategies and challenges in bringing a world class financial management system worthy of a global military enterprise. In the doing of great things, small things matter. Each one of the $373 billion to be spent this fiscal year by the Pentagon, seals a bond of trust between taxpayers and the citizen soldiers sworn to defend our way of life. Each must be accounted for.

Twentieth century processes and systems built by accretion during the haze of the cold war will never give the President, the Congress or the public the clarity and perspective required to marshal scarce resources against 21st century threats. The urgency of the war on terrorism demands financial management systems as smart as our weaponry. We cannot afford a margin of error, militarily or fiscally.

One year ago, the Department released a study setting out specific strategies to include financial management in the sweeping transformation of U.S. Defense institutions. In the long-term, the plan calls for broad structural changes in establishment of a standardized architecture for DOD business processes. At the same time, the plan calls for pilot projects to model cost savings ideas and chip away at institutional and cultural resistance among and between defense agencies in the military service branches.

As we will hear from GAO and the Department of Defense IG, this is not the first ambitious reform plan launched by a new administration charting a course over the fiscal and political horizon. Previous plans floundered in the shallowest of changing priorities and management neglect. But the Secretary of Defense and the DOD comptroller have committed to a sustained far reaching effort to reform and transform Pentagon financial management into a precision tool of policy formulation, program execution and detailed accountability.

Today, we ask our witnesses to measure progress to date to evaluate year and long-term measures of success and describe the daunting challenges that remain on the path toward modern auditable financial management systems at DOD. We appreciate their joining us this morning and we look forward to all their testimony.

[The prepared statement of Hon. Christopher Shays follows:]

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Statement of Rep. Christopher Shays
June 4, 2002

Last Friday, the Office of Management and Budget (OMB) transmitted the 2002 Financial Management Report to Congress. According to that report, "The largest impediment to removing the disclaimer from the government-wide financial statements remains the Department of Defense's (DOD) serious financial management problems. These problems are pervasive, complex, long-standing and deeply rooted in virtually all business operations throughout the department."

More than one year ago, David Walker, the Comptroller General and head of the General Accounting Office (GAO) sounded a similar alarm. He told this Subcommittee DOD suffered "pervasive weaknesses in its financial management systems, operations, and controls, including an inability to compile financial statements that comply with generally accepted government accounting principles."

Today, at the urging of our Ranking Member, Mr. Kucinich, the Subcommittee asks the Defense Department, GAO, the DOD Inspector General (IG) and others to describe current strategies and challenges in building a world class financial management system worthy of a global military enterprise.

In the doing of great things, small things matter. Each one of the $373 billion to be spent this fiscal year by the Pentagon seals a bond of trust between taxpayers and the citizen-soldiers sworn to defend our way of life. Each must be accounted for. Twentieth Century processes and systems, built by accretion during the haze of the Cold War, will never give the President, the Congress, or the public the clarity and perspective required to marshal scarce resources against Twenty-first Century threats. The urgency of the war on terrorism demands financial management systems as smart as our weaponry. We cannot afford a margin of error - militarily or fiscally.

One year ago, the Department released a study setting out specific strategies to include financial management in the sweeping transformation of U.S. defense institutions. In the long term, the plan calls for broad structural changes and establishment of a standardized architecture for DOD business processes. At the same time, the plan calls for pilot projects to model cost saving ideas and chip away at institutional and cultural resistance among and between Defense agencies and the military service branches.

As we will hear from GAO and the Department of Defense IG, this is not the first ambitious reform plan launched by a new administration charting a course far over the visible fiscal and political horizons. Previous plans foundered in the shallows of changing priorities and management neglect. But the Secretary of Defense and the DOD Comptroller have committed to a sustained, far-reaching effort to reform and transform Pentagon financial management into a precision tool of policy formulation, program execution and detailed accountability.

Today, we ask all our witnesses to measure progress to date, to evaluate near and long term measures of success, and to describe the daunting challenges that remain on the path toward modern, auditable financial management systems at DOD.

We appreciate their joining us this morning, and we look forward to their testimony.

Mr. SHAYS. At this time, I would like to call on Mr. Kucinich, the ranking member of this committee and the driving force behind this hearing.

Mr. KUCINICH. I want to thank the chairman for his indulgence and his cooperation in putting together this critical hearing, and I want to thank all the witnesses who are here today for appearing before this committee and also welcome my colleague, Mr. Tierney. Today marks the eighth hearing this subcommittee has held relating to the Department of Defense's financial management or mismanagement problems during the 107th Congress. The Subcommittee on Government Efficiency, Financial Management and International Relations, chaired by Representative Horn, has also held hearings on the subject.

The House Armed Services Committee also has heard testimony about the Pentagon's accounting troubles. So has the Senate Armed Services Committee and other Senate panels, but we needn't stop there. Since the Chief Financial Officers Act of 1990 which established basic financial reporting requirements for Federal agencies took effect, this subcommittee has held dozens of hearings on the Defense Department's financial mismanagement difficulties.

In all these sessions no matter who has testified, comptroller general, the Inspector General, the chairman of Independent Commissions such as Mr. Friedman, who is with us today, the message has been constant that the Defense Department's financial mismanagement situation or management situation is in shambles. That no major part of the Defense Department has ever passed the test of an independent audit, that the Pentagon cannot properly account for trillions of dollars in transactions.

I want to run that by you one more time; that the Department of Defense cannot properly account for trillions of dollars in transactions. That's no less than six Pentagon functions, more than any other government agency are at high risk of waste, fraud and abuse, and show little prospect for improvement, that the Department of Defense writes off as loss, tens of billions of dollars worth of intransit inventory, and that it stores billions worth of spare parts it doesn't need, that it will take nothing less than a complete transformation and culture at the Defense Department and a full commitment at the highest levels of leadership at the Pentagon to fix the situation.

Has the Defense Department culture been transformed? Is Pentagon leadership committed to rectifying this problem? In my estimation, no. In 1995, Department of Defense Comptroller John Hammery promised a Senate Armed Services subcommittee that he would take comprehensive action to sort out the accounting mess. Well, no real progress was made.

Six years and $1 billion in wasted taxpayers' money later, we had a remarkably similar statement from Secretary Rumsfeld during his confirmation hearing. Mr. Rumsfeld told Senator Byrd that balancing the Pentagon's books would be among the top priorities of his tenure. Once more in hindsight, the statement appears to be lacking. The Pentagon's books, of course, are a disaster. The Office of Secretary, despite the chairman's request inexplicably refused to send DOD comptroller, Dov Zakheim, to testify before this subcommittee, which has direct oversight over the Pentagon's manage-

ment policies. If cleaning up the books are so important to the Department, why isn't the Pentagon's top accounting official here to talk about it?

More importantly, the Pentagon still insists a preposterous 8 to 10-year timeframe for obtaining a clean audit. Can anyone fathom the chairman of commercial enterprise insisting to his shareholders that he needs a decade before its books are auditable? After all this country has been through, through the shame and sham of the Enron debacle, together with its colleagues in the accounting industry, notably Arthur Andersen, you look at that context and it pales when up against this mess at the Pentagon.

And there is also a question, Mr. Chairman, which is really beyond the scope of this meeting, but at some point would bear looking into, if the Department of Defense's accounting process is so jumbled and inexplicable, why wouldn't there be symmetry in so many of these defense contractors? Why wouldn't their books also be screwed up since so much of accounting is transactional analysis? Think about that. And we will talk about that later.

Meanwhile the administration has requested, and Congress will likely authorize one of the largest single-year increases in defense budget authority in the history of the world. Given its legendary problems, how can the Defense Department shareholders, the American taxpayers, be sure that the Department will spend this extra money on a measure that will increase security? As Chuck Spinney will tell us today, they can't. The truth is without proper accounting practices in place and accurate planning, there simply cannot be any rhyme or reason to the administration's defense budget request and there can be no way of ensuring that extra taxpayers dollars allocated to the Department of Defense will be spent appropriately.

In his written testimony, Mr. Spinney will put it starkly. At the Pentagon he tells us, quote, both links are broken. The historical books cannot pass the routine audits required by law and planning data systematically misrepresent the future consequences of current decisions. The double breakdown in these information links makes it impossible for decisionmakers to assemble the information needed to synthesize a coherent defense plan that is both accountable to the American people and responsive to the changing threats, opportunities and constraints of an uncertain world.

Personally Mr. Chairman I do not believe the Department of Defense will fix this broken unsustainable system on its own. What motivation does it have? Despite its routinely dreadful performance, Congress almost never rejects a Pentagon request for more money. The time has come for Congress to treat the Department of Defense as the market treats any commercial enterprise. Just as investors withhold their supply of capital to a company that fails to meet its expectations, Congress must refuse to supply additional funds to the Pentagon until its books are in order.

During recent consideration, the defense authorization bill for fiscal 2003, I drafted an amendment that would prevent 1 percent of the budget of any component of the Defense Department from being obligated if that component does not pass the test of an independent audit. This amount is small enough not to adversely affect the critical work conducted by our Armed Forces, especially given

the impending defense budget increase. And though a modest proposal, this amount is large enough to send a firm message from Congress that the status quo is unacceptable.

Though the House Committee on Rules blocked this amendment, the upcoming appropriations cycle offers another opportunity for Members of Congress to exercise our constitutional oversight responsibilities. I hope, Mr. Chairman, that our subcommittee and members of this subcommittee who, like me, have gained considerable firsthand knowledge of the Pentagon's failings, will join me in this effort. In the meantime, we have the opportunity to add to this body of knowledge, and in particular, hear from Mr. Spinney what at DOD's financial mismanagement means for the way we're able to defend our country. Whether the highest levels of Pentagon leadership which apparently deemed this hearing too inconsequential to send a representative absorb the message remains to be seen. I want to thank the Chair for his indulgence.

Mr. SHAYS. I thank the gentleman, Mr. Tierney.

Mr. TIERNEY. I am going to pass on a statement Mr. Chairman. I think the parameters of the meeting have been ably set out by you and Mr. Kucinich.

Mr. SHAYS. Thank the gentleman. We have two panels, two excellent panels. We have Mr. Stephen Friedman, chairman, Department of Defense Financial Management study group. He is with Marsh & McLennan Capital, Inc. Mr. Lawrence J. Lanzillotta, principal Deputy Under Secretary of Defense, Deputy Under Secretary Defense for Management Reform, Office of the Under Secretary of Defense. Accompanying him is Ms. Tina Jonas, Deputy Under Secretary of Defense for Financial Management, Office of the Under Secretary of Defense.

I would invite you to stand and we will swear you in.

[Witnesses sworn.]

Mr. SHAYS. Our witnesses have responded in the affirmative. Our practice is to do 5 minutes and then roll over another 5 minutes. So you will see the light go halfway through—you will see the light turn red at 5 minutes and then we'll turn it back on green again for another 5 minutes. And we will have two who will be providing testimony. And all three of you will be participating in the questions. And so we'll start with you, Mr. Friedman.

STATEMENTS OF STEPHEN FRIEDMAN, CHAIRMAN, DEPARTMENT OF DEFENSE FINANCIAL MANAGEMENT STUDY GROUP, HE MARSH & McLENNAN CAPITAL, INC.; LAWRENCE J. LANZILLOTTA, PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE, DEPUTY UNDER SECRETARY DEFENSE FOR MANAGEMENT REFORM, OFFICE OF THE UNDER SECRETARY OF DEFENSE, ACCOMPANIED BY TINA JONAS, DEPUTY UNDER SECRETARY OF DEFENSE FOR FINANCIAL MANAGEMENT, OFFICE OF THE UNDER SECRETARY OF DEFENSE

Mr. FRIEDMAN. Thank you very much, sir. Thank you, sir. Early in 2001, the Secretary of Defense asked if I would lead a task force to study and make recommendations concerning financial management transformation at the Department of Defense. We very quickly put together a group, selected a very capable consultant and waded into the process. The process was neither an audit nor an

exercise in fingerpointing. It was really designed to come up with hard recommendations.

We worked under a substantial sense that we should move quickly because there was an urgent desire to start implementing recommendations. The event it was possible to move very quickly and make recommendations with the high degree of confidence, and this is why: There had been numerous prior studies done of the Pentagon's financial management. I think both the chairman and the ranking minority member have alluded to them. They were highly consistent in terms of their criticisms and their diagnoses and the other thing that was highly consistent was the lack of effective widespread followup. We also found an enormous degree of consistency in our interviews with then present and past DOD senior officials and high consistency when we spoke to various consultants that we interviewed in the process of selecting the one we ultimately chose.

Additionally, many of the conditions that we saw there were to members of our panel were not unusual as things that would have occurred in the private sector many decades ago. Certainly totally unparallel as to what exists in the private sector today.

In the end, we were very taken by a comment that David Packard, the legendary business man and former Deputy Secretary of Defense made back in the 1980's, that we all know what needs to be done. The only question is why aren't we doing it?

So this is a very—this is a very target-rich environment for criticisms. What I would like to do is quickly tell you what we found, tell you why we believed it was that way and make some recommendations. Our full panoply of recommendations are spelled out in my report and the testimony I submitted, and there won't be time for that.

I do want to say that my remarks and the facts that I allude to are, as of April 2001, when our task force submitted its report and my understanding is that there is widespread agreement within defense on the conclusions and recommendations. But that, you will have to hear from the DOD officials. What we found, DOD was unable on a regular basis to produce timely, reliable and relevant financial reports. Clearly unable to meet the requirements of the CFO Act of 1990. Timely is self-defining. Reliable, to us, meant accurate numbers that could be confirmed by an audit, clearly crucial for the credibility and stewardship of an organization, but not enough. Managers don't run a major complex enterprise off the audited numbers. They really need management information systems, and that was where relevant came in. Numbers that would be useful to managers, numbers that would be useful to tracking costs, enabling benchmarks, it is an axiom in management that if you can't measure it you can't manage it. You have to be able to answer the question "how am I doing?" in a specific way, simplistic level. If you don't know how much it costs to maintain and cut the grass at a military base, it's very hard to know if your efficiency is improving or someone else could do it more effectively.

Going along with this, we found clearly a lack of widespread recognition of the benefits that good financial information could provide in managing the enterprise more efficiently and we're providing in the private sector. Lack of an authoritative plan enterprise

architecture was notable. Here you have the most complex enterprise in the world, the most stovepiped, and there was really a lack of an overarching and authoritative plan, and I want to emphasize "authoritative," the ability to insist that certain things be done right.

We found that the way business was being conducted, there was no real time line or cost estimates for reaching CFO Act compliance. It was over the horizon. It was just as someone said, not really in my lifetime. There was just no—there were no hard estimates. In addition to the credibility, numerous studies whether by the businessmen for national security [BNS], the Defense Science Board, others had pointed out the vast amounts of money that would be saved if modern financial management techniques were employed. BNS made a conservative estimate in a recent study of $15 to $30 billion annually. The conservative was the chairman's judgment. He felt it could be more. And there are—our task force thought of the weapons systems, the service readiness, the benefits to servicemen that would cover and clearly that was crucial.

Now, why? First of all, this is not an excuse but a fact, the Pentagon systems were set up to deal with budget and appropriations accounting, which is a form of checkbook accounting. It is, in many ways, more complex, at least to visitors from the private sector like me it is, and it's very different from GAAP, which they're being required to have in place.

Under the budgetary accounting as they had set it up, there was a lack of central data repository and just takes months to calculate things, like the total cost of ownership of a military track vehicle, for instance. Very, very important, the systems that grew up over the decades, hundreds and hundreds of feeder systems typically were at the service or lower levels were old, roughly 80 percent of the systems were not in the control of the DOD's central financial management. These feeder systems funneled information to DOD's central financial and accounting systems. Over the years, standardization and compatibility had not been mandated. These really couldn't speak to each other. On a very simplistic level, which is frankly the only level which I really get my arms around it, if you had a service person, let's say her name was Corporal Mary Jane Smith. If Corporal Smith was Smith, M.J. or Smith, Mary Jane, that makes a difference. If you add her birthdate, January 1, 1970, is that January 1, 1970, is it 1/1/70? Obviously these are highly simplistic examples but those vocabulary differences which seep into the business practices of the units meant that what you had was essentially something like a U.N. where many different languages were being spoken and you really have two choices in that situation.

You can either standardize the language, insist that certain things be expressed in certain common ways or you could translate and translation was, for the most part, the approach that they were taking. And that was an unfortunate approach, a bad compromise because it meant a huge sink of human resources at work and a constantly new workload because as new practices came in, the workarounds had to increase.

So year after year, in the absence of an authoritative plan, the central financial management worked toward what was, at the

time, most publicized problems. Some additional issues: DOD has some exceedingly convoluted business practices. If you look at pictograms of some of the processes, whether in travel service or service travel or procurement, they just have many more steps than would be the norm in the private sector, and by "private sector," I do not mean just corporations, I mean other entities that have not been shielded from competition and have to be effective at cost controls, such as hospitals or universities. Overly complex reporting requirements that have led to many, many reports that probably could have been streamlined and simplified.

Now the pertinence of all this is when you have many excess steps——

Mr. SHAYS. If you could finish in 1 minute. Thank you.

Mr. FRIEDMAN. When you have a lack of steps of interface like that, you essentially have a giant whisper down the valley. So in closing, I would say our recommendations came down to the importance of having a blueprint, continuity of Secretary of Defense, urgency for this process, a focused sunset effort, and then working with DOD on its human capital strategy for developing the internal skill sets to meet with these challenges. Thank you.

Mr. SHAYS. Thank you.

[The prepared statement of Mr. Friedman follows:]

Statement of Stephen Friedman
Before the House Committee on Government Reform
Subcommittee on National Security, Veterans Affairs and International Relations
June 4, 2002

Mr. Chairman and members of the Subcommittee – Thank you for inviting me to discuss the study done last year -- **"Transforming the Department of Defense Financial Management: A Strategy for Change."**

TASKING: METHODOLOGY

Early in 2001, the Secretary of Defense asked me to lead a study to recommend a strategy for transforming DoD's financial management. There was an underlying urgency to this task, given that DoD is handicapped by an aged, poorly integrated and dysfunctional financial management system infrastructure. As a result, the Department's financial information lacks credibility with Congress and other consumers and is inadequate for the routine support of management decision-making. Repetitive audit reports verify the systemic problems; while they indicate some improvement, they illustrate the need for radical transformation in order to achieve real progress.

Pursuant to contract with DoD, the study was done under the auspices of the Institute for Defense Analysis (IDA). We promptly formed a study group of highly accomplished and experienced individuals that the Secretary and/or I had worked with previously. My colleagues were: James Denny, presently chairman of a biosciences firm, former vice chairman & CFO, Sears Roebuck; Rick Friedland, retired CEO and CFO of General Instrument; Donald Haider, professor of management at Northwestern's Kellogg School; Robert Hermann, former senior vice president, science and technology at United Technologies; former director, NRO; William Kelvie, retired executive vice president and CIO of Fannie Mae.

The group was non-partisan and our study was neither an audit nor an exercise in finger pointing. The process was as inclusive as time permitted; we interviewed widely and received a great deal of help from past and present senior DoD officials and numerous knowledgeable people within and without the Pentagon. After a selection process, we chose PricewaterhouseCoopers ("PwC") as consultants to the project, and worked intensively and closely with them. PwC provided what we wanted: extensive DoD experience; an ability to compare its financial operations to private sector best practices and procedures; and a 24/7 commitment to our mission.

We operated with a pressing time sensitivity; the Secretary wanted our action plan as soon as possible – tighter resolution could be provided later by his staff, and tactics should be subject to their discretion . This made great sense to us – assuming we could get a firm handle on the subject very quickly -- as everyone we talked to stressed the importance of commencing to implement initiatives as early as possible in the new Administration. Also, we welcomed the sense of priority.

Ultimately, we were able to meet this accelerated pace -- and generate in several months a report that in less time constrained circumstances would have taken substantially longer – with a high degree of confidence in the conclusions. There was a basic reason for this confidence – we were not ploughing new ground. Numerous good studies and reports on DoD financial management had been prepared over the years and they were remarkably consistent in their analysis, criticisms and recommendations. (A lack of broadly effective follow-up was equally consistent. While useful projects were being carried out, typically they were narrowly focused, and few of the recommendations had been implemented on a wide-scale basis.) Also, there was a high degree of consensus among our interviewees concerning the central problems and potential solutions -- similarly with the views of the respective consulting firms we interviewed in our selection process. I underscore this theme by noting that years ago, the legendary businessman and former Deputy Secretary of Defense, David Packard said, in relation to DoD business practices: "We all know what needs to be done; the question is why aren't we doing it?"

At some degree of granularity, this topic is exceedingly complex and involves great technical expertise, but that level of detail is well below the perspective that needed to concern us, or DoD's most senior management or, we would submit, this committee. Thus, our challenge was to recommend a pragmatic set of action steps leading to transformation, and the accountability for effecting them.

Our final report was issued in April 2001; in July 2001, I gave a news briefing at DoD concerning the study. My comments today draw heavily on both. To avoid repetition, I will highlight only the principal points and in conclusion lay out some perspectives, particularly as to support Congress can lend to a transformation program. To be clear: My information and the observations I express today are essentially as of the time our report was issued. My understanding is that DoD's senior leadership is in substantial concurrence with the views expressed in the report, and many of its recommendations are being acted on. But of that, you must hear from them.

WHAT WE FOUND

DoD cannot produce, on a timely and consistent basis, relevant and reliable financial and managerial information. This is reflected in the inability to produce clean financial reports automatically and to consistently generate succinct cost information, to guide effective decision-making.[1] Thus, for its latest fiscal year, DoD, was, once again, unable to meet the requirements of the Chief Financial Officers (CFO) Act of 1990, which calls for audited DoD wide financial statements.. Even more troublesome was the awareness that -- **the way business was being conducted -- compliance with the CFO Act remained out of reach, over the horizon – with no authoritative plan, time line or cost estimates.**

[1] Relevant financial information will assist managerial decision-making and tell managers the costs of forces or activities that they manage and the relationship of funding levels to output, capability or performance of those forces or activities. Reliable financial information will provide more accurate financial statements and be affirmed by a clean audit opinion.

At the time of our report, the support of management decision-making was generally not an objective of the financially based information being developed or planned for development. Budgets and appropriation systems were the primary driver for the vast majority of DoD's present financial system users. Since the CFO Act of 1990, the Federal government has moved to the development of private sector-like financial statements. However, even the traditional budgetary accounting function has been subject to sharp criticism and is the source of a serious credibility problem for DoD. (As a rough analogy, such budgetary accounting has been described as similar to checkbook bookkeeping, and it is very different from the accounting and systems necessary for Generally Accepted Accounting Principles (GAAP) statements.) These budget and appropriations systems preclude, in many cases, the use of commercial off-the-shelf software (COTS), without substantial reworking.

Systems were typically developed within functional areas at the Service level, or even lower levels, to automate existing processes, with little thought given to end-to-end processing. Throughout DoD a very large number of critical business operating systems funnel information to a smaller number of critical accounting systems and finance systems. Few of these systems speak the same language (charts of account, data elements) and fewer still provide automatic data feeds upstream – because **historically** such **standardization and compatibility have not been mandated.**

Accordingly, consolidation and interface development to integrate systems has been a necessary focus of the 1990's and currently. Labor intensive "work-arounds" and manual re-entry are often necessary; to ameliorate the unreliability and time lag in obtaining data to manage operations, off-line records are maintained to translate data from one system to another. This leads to frequent errors, which must be reconciled at great delay and cost. Balance sheet information was not maintained on a widespread scale, resulting in significant manual adjustments in many areas, including property accounts. Visualize a long "whisper down the valley" chain, with the predictable accompanying error rate.

Standardization is absolutely crucial to efficiency, yet differing practices by the Services have represented roadblocks. To date, DoD's efforts to improve financial information have focused primarily on obtaining reliable information, and a protracted effort involving people, systems and data still is required to reach the goal. But our study noted that **it is possible to reach the goal of reliable financial information -- and a clean audit opinion -- and still not have information that is relevant to managers.** A properly audited statement is requisite for credibility in the stewardship of the business, and is a necessary starting point for generating relevant information, but managers can't run a complex enterprise with such statements alone. A complementary effort is needed to ensure that DoD's management information systems also provide relevant information. This includes selecting performance metrics, linking them to costs and outputs, and institutionalizing their use in financial management information systems and management decision-making.

Deeply troubling to our group -- and others who have studied DoD over the years -- are the vast sums of money that could have been applied to military "teeth," or other taxpayer purposes, but were wasted because of obsolete methods, the costly practices of "stove pipes," and the failure to incorporate widely understood financial tools and techniques. **(A recent Business Executives**

for National Security study stated that adopting modern business practices could result in annual DoD savings conservatively estimated at $15-30 billion.)

DRILLING DEEPER: CERTAIN SITUATIONS AND PROBLEMS IN THE DoD ENVIRONMENT

- DoD lacked an overarching approach to enterprise financial management. Disparate and technologically dated systems are hampered by a lack of standardization or integration in end-to-end processing, both technologically and from a functional process perspective. **No single authoritative source was addressing, from a strategic and programmatic level, the key issues from *an end-to-end approach.***

  A void existed in the organizational structure with respect to developing and implementing such an overall strategy. Two chains of command within DoD perform finance and accounting functions[2]. The Defense Finance and Accounting Service (DFAS), reporting to the Office of the Under Secretary of Defense (Comptroller), is responsible for improving compliance of the General Fund and Working Capital Fund accounting and finance systems and the production of the Service financial statements. The Services, reporting directly up the chain to their respective Secretaries, are responsible for all data in their systems and for improving their feeder systems.

  Much effort has gone into the development of the annual Financial Management Improvement Plan ("FMIP"), but it is a work in process, does not include a complete inventory of DoD systems, and is cited as "perpetually out of date." The problems noted in audit reports are so overwhelming to DoD's staff, and the costs to fix them so large, that – **absent an authoritative financial management strategy – year after year DoD finds itself moving from one priority to another – usually to the one that received the most recent publicity.**

- **Modernization efforts are hampered by overly complex data requirements -- driven by appropriation funding rules and elaborate policies and procedures, many of which are outdated but "remain on the books."** Systems often carry with each transaction upwards of 60 to 100+ populated data fields, to identify the transaction according to internal and external reporting requirements. In general, this is substantially more than the private sector model, and a substantial number of excessive data fields severely hampers interoperability. Due to DoD's complexity and difficulty in streamlining (because of stovepipes, cultural issues and funding streams), appropriation funding rules, and the great number of disparate systems, it has a more complex problem than civilian agencies. When reporting requirements change, new and often unstandardized data fields are developed at the various relevant sources, and new interface crosswalks must be laboriously developed among systems. One can analogize this process to attempting to roll uphill a giant boulder -- which occasionally rolls part way down, causing a net loss of ground.

[2] Source: DoD FMIP, January 2001

- **DoD has many "convoluted" business processes – which fail to streamline excessive process steps – sometimes driven by historical accounting, operational and organizational structures.** Many processes are duplicated due to non-interfaced systems along the business process chain, often requiring new input of data by hand, and thereby increasing input errors. (Appendix A to our report depicts a DoD Service travel process, illustrating "Before" streamlining and "After." To illustrate that positive strides are possible, the "After" pictogram depicts drastically reduced: process steps, systems involved, and data re-keyed – with the expectation of sharply reduced errors.)

- **Since 1990, federal financial management standards have been in a state of flux and have provided a moving target for compliance**. Implementation of a policy frequently has been dependent on the interpretation of the system owner at the DFAS or Service level. Compounding the effect of such changes are the multiple systems that need to be modified each time a standard is modified. (Appendix A to our report depicts a timeline of Federal accounting legislation and pronouncements since 1990.)

- **Disproportionate DoD budget dollars appear to support non- or low-value added activities. Since useful managerial information is hard to extract, useful corrective action is hard to implement.** Historically, this has been coupled with a lack of widespread understanding in DoD of how financial information has helped in the private sector and can help the Department improve performance at lower cost.

- **Interviewees frequently commented on a widespread cultural bias toward the status quo – driven by bureaucratic habit and** what economists might call **"perverse disincentives" for change, and short timeframes of political appointees** who otherwise might serve as agents of change.

  For example, the effect of the current budget rules – "use or lose" – creates disincentives for finding cheaper, faster ways of doing things. Reallocation of funds under the influence of the current users is perceived to be quite limited. Requirements to manage the budget and the budget process cause managers to continuously be "out of sync" with current needs.

  Many of the issues uncovered in our research have been dealt with effectively in private industry, largely because the competitive forces of the marketplace have forced modernization. No similar imperative has existed for DoD. The Department needs change agents and drivers as effective as those that have made the private sector competitive and efficient.

- Within DoD's vast civilian managerial cadre, many conscientious and able people were laboring hard on projects intended to improve financial management. But some of them were the first to note that: **On the human resources front, DoD urgently requires an infusion of the technical and financial skill sets necessary to achieve integrated systems and modern financial management techniques.** In the course of DoD's downsizing in recent years, longevity was often a major criterion for retention -- typically not the private sector model of functional and performance value. As a result, new ideas,

skill sets, and modern ways of thinking are not sufficiently available – particularly in the context of the new demands placed on DoD financial management.

The private industry has far outstripped the government's ability to offer competitive pay scales and reward packages to technology workers, and advanced degree financial professionals, thereby limiting the ability to attract and retain the required skills. As a result, many note that DoD has "lost a generation" of workers. This turnover is expected to continue over the next five years as nearly half of senior government executives are expected to retire in this timeframe. This is both a problem and a real opportunity. **The potential fixes are few, and not mutually exclusive: raising pay scales to be competitive; recruiting mid-career experts for limited time spans; and engaging in substantial private sector partnering to deal with skill set deficiencies**.

VISION:

FINANCIAL MANAGEMENT IN DoD SHOULD BE FOCUSED ON: DELIVERING RELEVANT, RELIABLE AND TIMELY FINANCIAL INFORMATION ON A ROUTINE BASIS: TO SUPPORT MANAGEMENT DECISION-MAKING AND ENHANCE DOD'S FINANCIAL CREDIBILITY

Improved financial information will markedly improve the opportunities to:

- **Provide visibility to costs, which is a critical underpinning of efficiency improvement;**
- **Institutionalize the use of performance metrics** (output as contrasted to input metrics) tied to cost and relevant to the management of the Department. This process will enable DoD to **establish benchmarking standards;**
- **Identify and take action, on an on-going basis, on performance improvement** (cost and effectiveness) including private sector partnering, as appropriate;
- **Ensure clean audits and routine compliance with Federal financial standards** and related accounting and financial regulations; and
- **Increase the credibility and transparency of DoD's financially based information** with Congress, as well as OMB, and other oversight agencies that have critical responsibilities concerning DoD.

RECOMMENDATIONS: A TWIN-TRACK FINANCIAL MANAGEMENT FRAMEWORK

The Study Group recommended a Comptroller coordinated and directed, twin-track program for transformation (in coordination with the services, the ASD (C3I) and others):

(Track 1) Structural Change will require a lengthy timeframe and includes establishing a centralized oversight process under the Comptroller to develop standard, integrated financial intelligence systems. While this office would control resources for the transformation program, the components would actually manage the programs.

Major program tasks for this office should include:

- developing a Defense-wide Enterprise Architecture for all business operations;
- dictating core accounting standards (accounting transactions, Standard General Ledgers, attributes, and data elements);
- managing a comparison ("gap analysis") to this core for each system requesting funding;
- final decision-making authority for trade-offs and cost benefit decisions based on the gap analysis; and
- implementing a phased approach which will allow for important incremental success yearly.

(Track 2) Close-in Success calls for selecting and overseeing implementation of a limited number of intra-Service/cross-Service projects for major cost savings or other high-value benefit under a process led by the Comptroller; as discussed below, Track 2 also calls for assisting the SecDef in establishing and managing with a set of "Critical Success Factors" and "Dashboard Metrics," thus driving accountability. Track 2 should be used as a learning experience and model within DoD for using financial information to drive decision-making. Prime tools of such improvement would include Activity Based Costing (ABC) and benchmarking/best practices analysis to identify cost savings opportunities.

Certain Essential Elements of Transformation

For a Financial Transformation program to succeed, it must be – and be perceived as -- a high priority for the Secretary of Defense and senior leadership – both currently and in the future.

- DoD must recognize that the initiatives outlined here require doing business in a different way. The Department must adopt change management strategies and a strategic communication approach that conveys why these initiatives are important to the Secretary and DoD, how they will be implemented and measured, and the incentives to be utilized.
- Financial management priorities must be established on a timely basis and then enforced – and the number of priorities must be manageable and funded (past history has shown that having 50+ unintegrated priorities is not workable).

Changing Certain Rules: Working with Congress as well as OMB, GAO and others.

We recommended that, at an early stage, the Secretary and DoD's Comptroller should begin presenting the financial management transformation framework, as a work in progress, to the appropriate congressional committees, GAO, OMB, and other key influences. **Much can be done with DoD self-help, but all that is needed cannot be accomplished without Congressional understanding and support.** For example, elements of the human capital strategy, private sector partnering, the CFO Act implementation plan, budget reallocation transactions and related incentives, may require Congressional approval, or at least concurrence. If there are limits on Congressional support in various areas, it is best they be addressed and understood early in the program life cycle.

- ***Streamline and simplify***. Current requirements for tracking funding and providing reports to various Federal entities (Congress, OMB, Treasury, etc.) place an inordinate amount of complex information requirements on DoD that do not contribute to the performance of its mission. Such requirements can drive impractical business processes and make it harder to align processes to private sector-like practices. Many such requirements are self-imposed by DoD. **A focused "sunset" effort aimed at eliminating self-imposed, non-value added requirements and working with regulatory agencies and Congress to simplify other requirements will ease the burden and shift the focus to more mission related information.**

- ***Reallocating Dollars.*** Proper categorization and costing can provide managers across the Department with the financial information to manage resources more efficiently and, therefore, recommend to Congress any appropriate reallocations. The current budget process allows only a limited amount of flexibility to adjust to changing requirements.

- ***Auditable Financial Statements – Getting the "Clean" Opinion for DoD.*** Given the current state of financial management operations, this is a long-term process. A plan is needed, based on a "gap analysis" (i.e., what has to be fixed to get a clean opinion). Working with the GAO, the DoD Inspector General and the Service audit agencies is critical. The DoD should adopt the private sector model of working with audit teams "year round" to resolve issues and not simply wait for the annual audit "test."

  The plan should provide for interim successes. For example, we suggested that the Statement of Budgetary Resources, with focus, could receive a clean audit opinion in a much shorter timeframe. Building intermediate term success stories demonstrates progress and the Department's willingness to meet the spirit of the CFO Act.

Changing Enterprise Practices: Standardization of Business Processes, Systems and Data

- ***Standardization is essential to the interoperability of financial management and feeder systems***. It is difficult to overemphasize this. Standard data for "core accounting" elements enable systems to communicate effectively with each other; also, they facilitate the auditing process when transactions must be traced from the general ledger to the originating accounting event and vice-versa. **The current systems plan, as articulated in the FMIP,**

often takes the path of least resistance by allowing the Services and Defense Agencies to keep their own "traditional" standards and, through the use of translation tools and systems interface programs, attempts to turn them into DoD standards. Unfortunately, this approach encourages the continuation of old and potentially inefficient business practices and creates a very expensive systems maintenance problem down the road. DoD must stop that practice and drive core accounting transaction standards from the new DoD Comptroller organization referenced above, through the DFAS and the Services into all financial management and feeder systems. **With occasional exceptions, DoD should stop the practice of investing in systems that do not incorporate standardization.**

- ***Building a Bias toward Commercial-Off-the-Shelf (COTS) Software Solutions***. The Department generally cannot afford to custom build and maintain new financial management systems. We agreed that DoD has many unique elements and process issues. However, we also believed that the reluctance to accept COTS is reluctance in some areas to accept the business process changes that are mandated by this approach. We see a triple benefit here for the Department in accepting such changes: cost savings through the implementation of best business practices imbedded in COTS products; savings through less expensive and faster systems implementations; and systems which vendors can support and upgrade in future years. Return on investment (ROI) analysis should also be adopted in all software implementation decisions.

- ***Critical Success Factors.*** **Providing a framework to establish accountability begins with communicating SecDef strategic goals and "Critical Success Factors."** Critical Success Factors are "the 5-6 things that must go right" in the Secretary's view if DoD is to achieve its mission. In support of his Critical Success Factors, senior leadership under the SecDef would then organize their own objectives. Establishing the SecDef Critical Success Factors is key to initiating the "cascading effect" whereby his subordinates establish supporting objectives and related measurements, which can be regularly monitored.

  Developing Metrics. A set of financially based performance metrics needs to be developed to correspond with the SecDef Critical Success Factors and the supporting objectives of his subordinates.

- ***Driving Near-Term Improvements and Savings.*** As an example, problem disbursements and the related areas of contract close-out have high visibility, and may have prospects for near-term cost avoidance and savings, depending on appropriate write-down or closure decisions driven by cost/benefit analysis. With leadership, much can change and **DoD can use methodologies such as Activity Based Costing (ABC) and cost/benefit analysis comparisons to review more carefully its overhead structure and introduce process improvements.**

Human Capital Strategy

Availability of the necessary skill sets is absolutely critical to DoD's ability to achieve financial management transformation; currently DoD does not have an adequate supply of such talents. Additionally, there is no comprehensive human resource strategy in place today to address the

issue. Most discussions of human capital or human resources focus on the attraction, development, and retention of internal staff. However, in the private sector, as well as in entrepreneurial government practices, leaders have recognized that effective human capital strategies include accessing alternative sources of skills, including the use of private sector partnering, contracting, and shared service arrangements. They look at human capital strategy as including the full range of available people because they cannot afford to limit themselves as to who they can hire and retain. **For its financial management, DoD needs a human capital strategy that includes both internal elements and greater use of external elements.**

- In April 2002, a Congressionally chartered panel led by the Comptroller General of the United States issued its report on "the policies and procedures governing the transfer of commercial activities for the Federal Government from Government personnel to a Federal contractor..." and made recommendations intended to improve the process. (Improving the Sourcing Decisions of the Government). The report noted (p.108):

  > Outsourcing is increasingly used by commercial firms, as well as by state and local governments and many believe that the federal government should study and adopt the best practices in this area.

  It went on to say (p. 108):

  > Outsourcing is also often seen by the private sector as the most efficient way for the enterprise to gain access to skills and personnel outside the organization, to improve quality, and to enhance flexibility, innovation and cutting edge thinking.

A reading of the report, and our interviews, make clear that OMB Circular A-76 process, which sets policy for DoD's sourcing decisions for commercial-like services, is labyrinthine in its complexity and certainly not "best practice."

- ***Building Incentives for Transformation.*** In the environment we found, position, prestige, influence, etc. were often measured by traditional elements such as number of people managed, the size of the budget or the information controlled ("perverse incentives"). In such an environment, there is a relative lack of focus on major operational improvement and cost savings – and often negative incentives for managers to "stick their necks out." **The Department must develop a new incentive system that encourages performance improvement and information management transformation, and reward efficiencies and cost savings**. Such an incentive system must address personnel issues, as well as allowing organizations increasingly to take advantage of cost savings by retaining some portion of the money saved for matters accorded a high priority by Congress, the SecDef and the respective Service Secretary. The incentive system should also recognize top individual performance/promotions by the accomplishments or results achieved – not by the traditional view of managing to budget. Many managers are disinclined to take the undoubted pain involved in forcing change and efficiency if there is no recognition or reward to their unit or themselves.

CONCLUSION

Why the failure of DoD financial management described above? No one wants bad financial management. Indeed, we found many diligent people within DoD trying hard to improve matters – and doing many things they had a right to be proud of: always subject to the limits they operated under and the inadequate tools available to them.

Perhaps proponents of financial management reform have not been sufficiently effective in selling its "value proposition." (Though, personally, I found such reports as BENS "Tooth to Tail" study and the work of the Defense Science Board in the 90's to be highly persuasive.) Also, a tug of war between the "head office's" systems integration priorities, and the "subsidiaries'" desires for autonomy and sense of "exceptionalism," are generic managerial issues and not unique to DoD. Furthermore, arguments over standardization and compatibility have always needed to be faced in the private sector. (One of our study group members noted that DoD's systems configuration: "...looks just like a newly put together conglomerate in the '70's.")

My belief is that, over the years, there have been constituencies and lobbies for a range of other competitive priorities, presumably valid and important ones, which -- on an uncoordinated case-by-case and priority versus priority way – trumped financial management reform for priority. On the other hand, it is encouraging to note that when there was consensus of a widely perceived crisis --Y2K -- DoD was able to act with coordination and focus -- and got the job done!

Management everywhere is about ranking priorities – making trade-offs. The difference is that in the business world, or the hotly competitive not-for-profit sphere (such as hospitals, etc.), competition has ruthlessly forced accountability and change. Or else the enterprise doesn't survive – it's that Darwinian. Thankfully, our military is without peer in its core competence -- the most competitive activity there is. However, financial management has been another matter.

The end result – after many years of such trade-offs – is that the patient needs major surgery. Peter Drucker, the renowned expert on management, remarked about 40 years ago that, **"Any job that has defeated two or three men in succession...must be unfit for human beings..."**[3] The corollary is that the task of instituting financial management transformation at DoD, as defined and empowered, was destined for failure.

Changing the terms of the mission and providing the necessary empowerment was what our report addressed. Notwithstanding the discouraging history, we found cause for cautious optimism about the current potential for transformation. While the task is very hard, it is certainly doable. The Secretary and his senior leadership are determined and impatient to make reform happen – they recognize that the present financial tools severely handicap them and their successors.

Much of the necessary task is subject to self-help within DoD. Senior leadership's high priority and continuity of oversight – "finger in the chest" urgency, as it was expressed to us -- is a necessary condition. But, more is needed. This should be a "dual key" project. After reviewing the numerous elements of transformation described in our report that require action, or

[3] Quoted from Eliot A. Cohen's "A Tale of Two Secretaries," Foreign Affairs, May/June 2002, p. 34.

at least concurrence, on the part of Congress, our conclusion was that the other crucial key is in the hands of Congress.

Obviously, there are many other crucial priorities and values for the Department and for Congress beyond financial management transformation. In Pentagon-ese, "...it's above my pay grade" to weigh our recommendations against your other priorities. However, in the hope that a businessman's perspective may assist you, I want to suggest a framework for oversight of this transformation project. I recommend that Congress:

- Review the high-level plan DoD ultimately prepares for the architecture of a transformed financial management structure;

- Review the subsequent more granular elements of this plan: This should include a timeline with measurable milestones along the way, and cost estimates for the respective phases and for ultimate transformation;

- **Request that DoD stipulate the "elements of transformation" described above as to which they request Congressional action or concurrence -- and enable a process to determine what they can and cannot expect;**

- In the future, review performance relative to the phased plan and require accountability;

- **During future confirmation processes, consider as part of your criteria whether persons nominated for senior DoD posts understand and appreciate the importance of this program and are committed to its fulfillment.** (Continuity is crucial, particularly given the historically high turnover of similar DoD civilian appointees and the potential for bureaucrats to outwait change agents. Some things just need to be decided and stuck to unless proven wrong.

The success of an enterprise, or its discrete principal units, depends overwhelmingly on two things: the quality of its people and the vitality of its culture (sparked by leadership). If one accepts this viewpoint, **a crucial area in which DoD should seek your help is in their human capital strategy,** for example:

- pay scales and incentives to attract, retain and motivate accomplished financial and technical professionals,

- a readier ability to discharge weak performers, and

- more commercial-like practices for the private sector partnering of activities which are not inherently government.

Also, **a priority should be establishing a "sunset process,"** to identify reporting and process requirements that can be streamlined or eliminated. Elements of this process will require Congressional approval or at least concurrence.

* * * *

The catalyst for implementing a successful transformation program must be the empowerment and sense of urgency provided by Secretary Rumsfeld and his senior leadership -- with the Comptroller and his team as the necessary spear point – and close coordination with Congress. Financial transformation has been accomplished in the private sector on a widespread basis, with enormously beneficial results. Our interviews and discussions with senior representatives of DoD, current and past, led us to believe that DoD is ripe for change. Congress and DoD's leadership need and deserve better and more transparent financial information in order to follow Deputy Secretary of Defense Wolfowitz's admonition that we "engage our brains before we open the taxpayer's wallet."

June 4, 2002

Mr. SHAYS. Mr. Lanzillotta—do I say your name correctly?

Mr. LANZILLOTTA. Thank you, Mr. Chairman, and members of the committee. I am pleased to be here today to update you on the financial management reform within the Department of Defense. I have a short summary of my written statement that I have already submitted to the committee. Financial management reform and overall management reform in the Department of Defense are key in the need for transformation of America's defense posture.

Mostly transformation is about changing the way we think about military capabilities to ensure that we are able to counter more decisively 21st century threats, most notably, terrorism. However, in streamlining the overall Defense Department's support structure, its management and infrastructure and organization, it is critical to free up resources necessary to carry out this transformation. The support structure must be responsive to our fighting forces and leadership and be as efficient as possible.

What makes transformation different and historic is that Secretary Rumsfeld and the entire leadership team are moving to change the fundamental culture of the Department. The Department is focusing on the big picture to get to the root of the problem and carry out reform that will endure and engender other improvements. The culture change is being advanced by Secretary Rumsfeld and is evident in his actions to reform business practices and the supporting financial management systems. Our approach has been an important distinguishing feature from past endeavors. Most significantly our financial management reform is leadership driven. This is a top down effort. Past reforms were bottom up that was a piecemeal approach, which only yielded marginal change and were unable to achieve the needed cultural changes in the comprehensive solution.

Dividing the problem into smaller pieces seemed like a reasonable solution, but it just became just as inexecutable as the past solutions. General reform cannot simply be left to functional staffs. Reflecting this, Secretary Rumsfeld and the three service secretaries and the Department's entire senior staff are deeply involved in overhauling financial management. Leading Secretary Rumsfeld's financial management reform is my boss, Under Secretary of Defense, Dov Zakheim. Directing and overseeing this reform is Ms. Tina Jonas, who sits off to my left, who is the first-ever Deputy Under Secretary of Defense for Financial Reform. She is with me today.

The Comptroller's Office is already being reorganized and realigned to better address this problem. It was new and it's new to this administration to put assets totally devoted toward doing this problem. We added a Deputy Under Secretary and we realigned the Comptroller's Office to have not only a directorate that dealt with this, but a program management office that deals directly with this problem. Besides being leadership driven, would also distinguish our reform as its comprehensive centerpiece, seamlessly linking our reengineering business practices and our financial information systems.

DOD's financial management can only be put right by reengineering our business practices and developing an overarching architecture to provide the information needed to guide and ac-

count for management decisions. Development of an enterprise-wide architecture will be driven by the needs of the Department's decisionmakers for timely and reliable information and reengineering the Department's business practices.

Additionally, a well-designed business management system will enable us to produce not only relevant management information, but also auditable compliant financial statements and to fulfill other financial information management requirements. Our reform efforts are drawing on private sector enterprise. This includes not only the expertise brought into the office by Secretary Rumsfeld and the service secretaries and many of his leadership team, but also the establishment of direct links to private industry.

Shortly after he took office, Secretary Rumsfeld called upon some of our most capable minds in private and public financial worlds to describe processes for fixing DOD financial management. The committee has already heard from Mr. Friedman, who led some of our initial efforts. Mr. Friedman's qualifications are well known to this committee. Last year he produced a study that became a guidepost for the Department's efforts in improving financial management information.

Following his recommendations proposed by Mr. Friedman and his team, the Secretary focused his reform on overhauling the current disjointed complex DOD financial and nonfinancial business systems. Beyond this initial input, private sector expertise remains key to our reform. For example, the Defense Business Practice Implementation Board is giving us insight and independent recommendations. We believe the design of our defense-wide architecture will benefit from substantial private sector input. Supporting the Department's financial management overhaul are several reforms that likewise will seek a cultural change in how the Department does business. The Department's efforts will focus on performance-based budgeting and other features outlined in the President's management agenda.

DOD leaders need to be given greater freedom to manage. Reporting requirements and other administrative burdens must be reduced. These and other reforms, like financial management change, will require strong support from the Congress.

In closing, Mr. Chairman, I want to reiterate Secretary Rumsfeld's support and determination for transforming business processes within the Department. We are advancing a cultural change in how we do business in a comprehensive overhaul of our management and financial business systems. I thank the committee for its continued interest in our management reform. We will need strong support from Congress to achieve historical transformation we seek. We also need ongoing strong partnership with the General Accounting Office, Office of Management and Budget, the Department's Inspector General. Together we can create the world class business infrastructure that is needed to revitalize and transform America's defense posture.

Mr. SHAYS. Thank you very much.

[The prepared statement of Mr. Lanzillotta follows:]

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HOUSE COMMITTEE ON
GOVERNMENT REFORM

STATEMENT OF

Larry J. Lanzillotta

Principal Deputy Under Secretary of Defense (Comptroller)
And Deputy Under Secretary of Defense
for Management Reform

BEFORE THE

House Committee on Government Reform

Subcommittee on National Security, Veterans Affairs, and International Relations

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Mr. Chairman and members of the Committee, I am pleased to be here to update you on financial management reform within the Department of Defense (DoD).

A CULTURAL CHANGE IN DOD MANAGEMENT

Financial management reform and overall management reform in the Department of Defense are key components of the needed transformation of America's defense posture. Mostly this transformation is about fielding revolutionary new military capabilities to enable us to counter more decisively 21st century threats – most notably, terrorism. Also critical, however, is to streamline and overhaul the Department's support structure: its management, infrastructure, and organizations. The support structure must be optimally responsive to our fighting forces and DoD leadership, and be as efficient as possible.

What makes this transformation different and historic is that Secretary Rumsfeld and our entire leadership team are moving to change the fundamental culture of the Department. Instead of stovepipe solutions, the Secretary wants to focus on the big picture, get to the root of the problem, and carry out reforms that will endure and engender other improvements.

The cultural change being advanced by Secretary Rumsfeld is evident in his actions to reform DoD business practices and their supporting financial management systems. Our approach has important distinguishing features.

Most significantly, our financial management reform is leadership-driven. This is a top-down effort. Past reforms took a piecemeal approach, which yielded only marginal changes – and were unable to achieve needed cultural changes and comprehensive solutions. Genuine reform cannot simply be left to functional staffs of accountants and financial specialists. Reflecting this, Secretary Rumsfeld, his three Service Secretaries, and the Department's entire senior staff are deeply involved in the overhaul of financial management.

Leading Secretary Rumsfeld's financial management reform is my boss – the Under Secretary of Defense (Comptroller) Dr. Dov Zakheim. Directly overseeing reforms is Ms. Tina Jonas, who is the Department's first-ever Deputy Under Secretary of Defense for Financial Management. She is with me today.

Besides being leadership-driven, what also distinguishes our reform is its comprehensive centerpiece: a Defense-wide Enterprise Architecture – seamlessly linking our reengineered business practices and our financial information systems. DoD financial management can only be put right by reengineering our business processes and developing an overarching architecture to provide the information needed to guide and account for management decisions.

Development of the Defense-wide Enterprise Architecture will be driven primarily by the needs of DoD decisionmakers for timely and reliable information and the reengineering of the Department's business practices. Additionally, a well-designed business management system will enable us to produce not only relevant management information, but also auditable, compliant financial statements -- and to fulfill all other information management requirements.

Another distinguishing feature of our reforms is that we are drawing on private sector expertise. This includes not only the expertise brought into office by Secretary Rumsfeld, the Service Secretaries, and many in his leadership team, but also the establishment of direct links to private industry. Shortly after he took office, Secretary Rumsfeld called upon some of the brightest minds in the private and public financial worlds to prescribe a process to fix DoD financial management. Sitting next to me is Mr. Steve Friedman, who led this effort. Mr. Friedman is a renowned leader in financial services investment banking. Last year he produced a study that became a guidepost for the Department's effort to improve its management information systems. Following the recommendations proposed by Mr. Friedman and his team, the Secretary focused his reform on overhauling the current disjointed complex of DoD financial and non-financial business systems.

Beyond this initial input, private sector expertise remains key to our reform. For example, the Defense Business Practices Implementation Board is giving us insightful, independent recommendations. And the design of our Defense-wide Enterprise Architecture will benefit from substantial private sector input.

Supporting Secretary Rumsfeld's financial management overhaul are several reforms that likewise seek a cultural change is how the Department does business. The Department's efforts will be focused on performance-based budgeting and other features outlined in the President's Management Agenda. DoD leaders need to be given greater freedom to manage. Reporting requirements and other administrative burdens must be reduced. These other reforms -- like our financial management changes -- will require strong support from Congress.

SUMMARY OF FINANCIAL MANAGEMENT REFORMS

Having illustrated the cultural change underway for how the Department of Defense does business, let me highlight the major steps to our financial management reform. We are:

1) Building a Defense-wide Enterprise Architecture, to include renovating our business processes and business information systems.

2) Improving the quality of the processes we use to prepare financial statements.

3) Working to ensure DoD Components safeguard their assets from fraud, waste, and abuse.

4) Developing and using performance measures to target areas for improvement.

5) Transforming the Department's financial workforce by increasing its qualifications, skills, and motivational incentives.

The remainder of this statement further details our financial management reforms and our progress to date.

BUILDING AN ENTERPRISE ARCHITECTURE

Our first step toward financial reform is building a Defense-wide Enterprise Architecture. In this sense, our program goes far beyond our past efforts to reform financial management. Our program targets two of the primary root causes of the Department's problems: The uncontrolled proliferation of antiquated and standalone financial management systems and the inefficient business processes that they support.

It is important to note that our financial systems and processes were developed in the 1980's as stovepipe systems to support the budget and appropriations process. Therefore, they unfortunately do not generate the type of crosscutting, corporate financial information that meets the needs of the Department's decisionmakers. And, they do not incorporate standard accounting requirements as required by the Federal Financial Management Improvement Act of 1996. We intend to fix that.

Indicating the difficulty of achieving an integrated business information system, we have identified over 1000 systems that produce most of the Department's financial management information. The great majority of these systems manage personnel, logistics, health care and other non-financial functions. Because they generate financial data, they are as important to financial management reform as accounting systems. Cataloging these many systems has been a major achievement of the past several months and an important prerequisite to reform.

Our objective is to transform this antiquated financial management infrastructure. We are doing this by modernizing the business processes that produce our financial information, eliminating as many systems as possible, and integrating and standardizing those that remain.

Complete stoppage of all information technology systems funding, as some have suggested, would negatively impact the mission of the Department. In August and October 2001, Dr. Zakheim issued policy designed to constrain technology investments for new developmental and system modification initiatives during the design phase of the Enterprise Architecture. Under this policy, however, our information systems will still need to be maintained and enhanced to support the Department's national security mission.

The Enterprise Architecture we are creating will serve as a plan of action linking systems and business processes in a comprehensive and integrated fashion. These processes are now isolated from each other, across the functional areas I mentioned earlier: logistics, health care, accounting, finance, and others. Our Enterprise Architecture will also outline Department-wide financial management standards and prescribe stringent internal controls. We awarded a contract for the development of the architecture on April 9th and expect to finish it by March 2003. We will then begin testing--or "prototyping"--the solution we developed in our architecture in early 2004.

IMPROVING FINANCIAL STATEMENTS

Our second reform step is improving the processes we use to prepare financial statements. This will help us address many of the Department's most intractable financial problems, including those that prevent the Department from receiving a "clean" audit opinion on its financial statements. We are already making progress in several key areas. For example:

1) We are working with the Federal Accounting Standards Advisory Board to change the way DoD accounts for ships, tanks, aircraft, and other military equipment. We want to record their full costs in our accounts and show those costs on our balance sheet. This will give our managers, and the public, a clearer view of the total costs associated with these items.

2) We are developing more accurate methods to estimate our environmental liabilities. These new methods will help the Department report reliable estimates for its clean-up costs.

3) We are improving our ability to estimate retiree health care costs. Our enhanced quality control program will enable us to budget for future health care costs more accurately. Our goal is to improve the quality of health care for our retirees.

4) We are balancing our checkbook with the U.S. Treasury. Knowing how much money we have in our Treasury accounts helps to ensure that we spend only the funds appropriated to us by Congress.

5) We have made considerable progress documenting adjustments to our books, thus improving audit trails. The Defense Finance and Accounting Service (DFAS) added management reviews, upgraded documentation requirements, and introduced additional reconciliation requirements. These improved procedures have reduced our adjustments by half, and we intend to achieve further reductions.

IMPROVING INTERNAL CONTROLS

Our third reform step is improving internal controls to prevent fraud, waste, and abuse. We are making enforcement of internal controls a top priority.

While we are looking very closely at our overall internal control program, we are focusing specifically on preventing the misuse of government charge cards. Our charge card program is essential to implementing best business practices in the Department. The misuse of charge cards is not universal, but any misuse is unacceptable and must be prevented.

In mid-March Secretary Rumsfeld directed Dr. Zakheim to take charge of reforming charge card use. On March 27, Dr. Zakheim announced a multi-pronged initiative to prevent charge card misuse, and we are continuing to advance that initiative. We are doing all we can to punish wrongdoers, and taking numerous actions to prevent future misuse. Of special note, we are:

- Working to advance legislative proposals to address pecuniary liability of supervisors and card users, mandatory salary offsets, and related items.

- Proposing better training of supervisors and cardholders -- plus stronger internal controls, including use of data mining tools. We aim to implement these changes soon.

- Establishing metrics to measure progress and success.

- Strengthening enforcement by changing the culture surrounding the use of all types of government charge cards.

- Increasing accountability for the use of these cards.

As I said, we are aggressively pursuing all available administrative and criminal remedies for charge card fraud. We are working with the Department's Inspector General and the Service Audit Agencies to implement improvements over internal controls and ensure compliance with existing controls.

MEASURING PERFORMANCE

Our fourth reform step entails developing and using performance measures to target areas for improvement. This step reflects Secretary Rumsfeld's philosophy--"that which you measure, improves". Our data shows that we already have been successful in using measures to improve performance:

1) We are doing a better job of paying bills on time. From January 2001 to March 2002, we reduced the backlog of commercial payments by 30 percent. This improves our business relationships and reduces wasteful interest payments.

2) We are doing a better job of accurately recording payments. We decreased our payment recording errors by 47 percent between January 2001 and February 2002. The elements of this reduction include:
   - A 46 percent reduction in the dollar value of our unmatched transactions,
   - A 79 percent reduction in the dollar value of our transactions not obligated, and
   - A 66 percent reduction in the dollar value of transactions requiring added research.
   - A 33 percent reduction in the time to resolve unreconciled balances.

3) We are aggressively collecting money that contractors owe us. The Defense Contract Audit Agency (DCAA) and Defense Finance and Accounting Service (DFAS) are working together to identify and collect contract overpayments. As of April 30, 2002, our auditors have found FY 2002 overpayments of $75 million, with over $57 million of the overpayments already returned to the government. We are working to recover the balance. DCAA finished audits of contractor overpayments with 93 major contractors and is completing audits at 108 others.

TRANSFORMING OUR WORKFORCE

The fifth step in the successful transformation of the Department's finances is to achieve a more highly motivated and professional financial workforce. Secretary Rumsfeld has spoken repeatedly of the need to improve the professional qualifications and skills of the Department's workforce.

We formed a financial management human capital workgroup to create a detailed plan to bolster the talent and experience of our financial workforce. The workgroup is developing incentives that encourage personnel to attain recognized professional credentials, such as Certified Public Accountant. The Defense Finance and Accounting Service and Defense Contract Audit Agency, the Department's two major financial agencies, are both members of the workgroup. This is the first time that these two agencies have worked together in this kind of endeavor. We are integrating the proposals developed by this group into our overall transformation initiative. The workgroup will be reporting its recommendations and findings in the very near future.

The Department of Defense thanks the Congress for its work last year in allowing us to reimburse employees for their achievement of degrees and certifications we have found helpful in our efforts to improve DoD financial management.

CONGRESSIONAL SUPPORT

We cannot reform financial management in the Department without the strong support of Congress. We need your help to:

1) Approve our FY 2003 budget request for Financial Management Modernization.

2) Improve flexibility in our budgetary processes.

3) Reduce the excessive administrative reporting burden our managers suffer under. Our managers simply spend too much time submitting reports of marginal value.

4) Streamline the personnel hiring and retention process. We need to be competitive with private industry in the employment market.

5) Upgrade the talents and experience of our workforce. We want more of our financial professionals to be Certified Public Accountants, and have advanced degrees.

CLOSING

In closing, I want to reiterate Secretary Rumsfeld's support and determination to transform business processes within the Department of Defense. We are advancing a cultural change in how we do business and a comprehensive overhaul of our management and financial business systems.

I thank this committee for its continuing interest in our management reform. We will need strong support from the Congress to achieve the historic transformation we seek. We will also need an ongoing strong partnership with the General Accounting Office, the Office of Management and Budget, and the Department's Inspector General. Together, we can create the world-class business infrastructure that will be needed to revitalize and transform America's defense posture. Thank you, Mr. Chairman.

Mr. SHAYS. Ms. Jonas, I think before we start, I would like you to explain that chart so we don't think it's wallpaper.

Ms. JONAS. Mr. Chairman, when we came in, I got to the Department in April of last year. And when we came in, of course we had Mr. Friedman's study available to us and a plethora of GAO and IG reports to tell us generally that there was a concern about our systems and our financial accounting infrastructure, but we did not know the full extent of the problem. The only documentation that existed was a report that was provided to Congress called an improvement plan. That document suggested that there were 167 critical financial systems. So we decided to make sure that we had the facts straight and in July, the Secretary mandated the development of a program management office and began the Financial Management Modernization Program.

Over the several months after that memo was issued, we discovered the full scope and breadth of the problem. There are 1,127 different financial and nonfinancial feeder systems on this board. It represents a specific data base of information. It's not just a picture. But this is—what they call this is the development of what they call an "as-is" inventory. This is what our current business environment, our accounting environment looks like, and as you can see, it is quite complex.

So on that board, you'll see some of the colors represent the different systems I think we may have provided the committee. For example, we've got property management systems, inventory systems, budget formulation systems, acquisition systems, personnel and payroll systems represented on that board. We do have a key to that.

Mr. SHAYS. We do have a copy of that. I want Mr. Kucinich to start the questioning process. I want to set this up to understand, is there an axis—is there anything—is there a sense of order to these squares or could you have arranged them any way you wanted?

Ms. JONAS. It does represent a particular data.

Mr. SHAYS. Is there a flow-through?

Ms. JONAS. Well, what you see, those black lines represent financial transactions or interfaces between the various systems. So we have approximately 3,500 interfaces. What this illustrates, Mr. Chairman, is that it is impossible to be accurate or timely with this type of business environment. People wonder why we can't get a clean audit statement. You know, the further you get out from one of the core accounting systems, the more likely it is that an error will have been made.

Mr. SHAYS. Well, I have questions specifically about this. Let me just understand, when did both of you join the Department of Defense? Have you been there a long time?

Mr. LANZILLOTTA. Tina and I actually came on the same day, and it's been a year and a month.

Mr. SHAYS. Let me get some housekeeping out of the way and then we will go with Mr. Kucinich for 10 minutes. We'll do 10-minute rounds and come back. Ask unanimous consent that all members of the subcommittee be permitted to place an opening statement in the record and the record remain open for 3 days for that purpose. Without objection so ordered.

And ask further unanimous consent ask all witnesses be permitted to include their written statements in the record. Without objection so ordered.

And so, Mr. Kucinich, you have 10 minutes, and Mr. Tierney will go with 10 minutes and then I'll do 10 and then we'll keep going around.

Mr. KUCINICH. I thank the Chair and the witnesses to Mr. Lanzillotta. Secretary Rumsfeld has indicated that implementing financial reform could take as long as 8 more years. Wouldn't you agree this is an extremely long period of time in which violations of the Constitution itself comes into question, to remain out of compliance with Federal accounting statutes, and most importantly, to operate without the ability to make rational planning decisions? I am sure you are familiar with Article 1, Section 9, Clause 7 of the Constitution, a regular statement and account of the receipts and expenditures of all public money shall be published from time to time.

Mr. LANZILLOTTA. Secretary Rumsfeld is not pleased he has to wait any period of time. He would like this financial management and get this thing done as soon as possible. The problem, I think, as Tina brought forth, is the complexity of the systems that we got in and dealt with. You know, we have right now on financial transactions and systems that we're dealing with, 1,127 systems that we're trying to make them compliant. The best way to do that is the approach that I think the Department, and I think it's been recommended by Mr. Friedman and GAO and IG and everybody else that we have sought guidance from, is to develop this enterprise, this architecture. That way we can develop an overall plan to become compliant and provide not just clean auditable statements but also the management information that the Department needs.

Mr. KUCINICH. How do you justify 8 years? How do I go back and tell my constituents that this $400 billion a year enterprise it's going to take them 8 years to straighten out?

Mr. LANZILLOTTA. I am not pleased with the timeframe. I think we can probably do it faster. And I think there will be successes along the way. We have some successes now and we hope to have more successes. I think when you talk about 8 years, that you talk about total 100 percent. If you look at Gillette and some of the major corporations of the United States that did similar activities, and, of course, I don't know where we stack up on the Standard & Poor's 500, but I suspect the first 200 of them at least, the UK took 4 years, Gillette took 4 years, Hershey took almost 3 years and these are individual efforts that took 3 years. We're not happy that we found the complexity of the problem that we found. We're trying to deal with it in an orderly way and we have sought input from everybody we could to try to do this.

Will it take 7 years? It may. That's a reasonable estimate, and I think the GAO thinks it's a reasonable estimate. Do we hope to do it faster? Yes. Some of the criticism that we have taken is that our plan is too aggressive.

Mr. KUCINICH. Wouldn't it be a lot easier for your task if the—if Pentagon spending was just frozen so you could get the books in

order instead of bringing in more cash that is going to be a lot harder to follow?

Mr. LANZILLOTTA. Sir, it would be easier for me. It certainly would be.

Mr. KUCINICH. I want to ask you about the repercussions of taking this long. I'm sorry to cut you off. I got a lot of questions here. Mr. Friedman, I have heard it indicated by Secretary Rumsfeld and by yourself that these reforms that you are recommending could take $15 billion to $30 billion annually—could save that much once it's finally implemented. Let's invert that rational for a moment. Isn't the Pentagon losing at least that much every year that you don't have those reforms in place.

Mr. FRIEDMAN. The numbers that I cited were from the Businessmen for National Security, and it was 15 to 30. I believe the Secretary at one point mentioned a target of 5 percent; is that right? There are large amounts of money and no one can be precise that would be saved if modern business practices were in place. I don't think anyone who has looked at the Department of Defense has disputed that.

Mr. KUCINICH. What I would like to say, though, since you put it that way, I think it's equally valid to put it another way, and that is when you don't have those reforms in place, that it could be costing the American taxpayers anywhere from $15 to $30 billion annually not having the reforms in place, and that could be anywhere from $120 billion to $240 billion over the next 8 years. Isn't the inverse true?

Mr. FRIEDMAN. I think that's right. That money could be used for other taxpayer purposes or used for defense purposes, weapon systems, advancing readiness, service peoples' benefits.

Mr. KUCINICH. I want to ask Ms. Jonas, you indicated in a meeting with one of my staffers that one of the problems, at least in terms of incentives is with us, if Congress keeps appropriating more and more money despite these horrendous practices, what's the incentive for the Pentagon to reform?

Ms. JONAS. Well, I think the Secretary is trying to create the incentive. I think Steve just referred to the general thought. You know, just as an example, the Department spends—has spent about $2 million a month on interest penalties that we pay because we don't pay on time. So I am—currently we have measurements that we are tracking this to reduce that.

Mr. KUCINICH. Run that by us again.

Ms. JONAS. The Department pays approximately $2 million a month on interest because we don't pay on time. This is under the Prompt Payment Act. So we have since January of this year, we have had metrics and measures that Steve referred to where we track and are——

Mr. KUCINICH. Who do you pay the interest to?

Ms. JONAS. Contractors. I mean we are paying about $11 billion. It's a small percentage and a lot better than the other government agencies, but it illustrates the point. And I make it to people in the building all the time because clearly when they're looking for money for reprogrammings or other programs, this is an area where if we improve our process and our performance, we can save money and become more efficient. So those are the types of things

we're using and I've got about 125 different measures that we're now using to improve our performance.

Mr. KUCINICH. If a contractor knows they're going to get interest on the amount of money that's not being paid, there's an incentive for them not to press for payment, isn't there?

Mr. LANZILLOTTA. I don't think that would be the case, sir. Every contractor that's come to me, both in this job and my previous job, they want to be paid on time. If they're not on time, they want to be paid earlier. The incentive is just the opposite. They don't want to have to finance their receivables and they don't want us to be late in paying them. I find that to be opposite from my experience.

I would like, sir, if I could, clarify my last statement, making it easier for us in the Department to fix the financial systems would fix the financial systems, but it would neglect our primary mission of national security. Our requirements aren't driven by budgetary increases. Pay raises is a very definite number that comes to mind, and we know exactly what that requirement is. We don't want to stop on flying hours. We know exactly what that requirement is, steaming days, OPTEMPO. Stopping the systems and no funding for these requirements, although it would be easy to fix the financial management, but it would be like throwing the baby out with the bath water because our problem is complicated in the fact that when we prepare our statements, only 20 percent of those systems actually would go to fixing financial statements. The other 80 percent are what's called feeder systems. So when we look at this problem, we have to look across the entire Department to get this fixed.

Mr. KUCINICH. One of the things I am wondering as we go through this thing, Mr. Chairman, and the importance of this hearing is that so we don't get drawn into this maze without asking some obvious questions, how can the American people be assured that our national security is solid when the accounting system which is the basis of it because you're talking about how the money's spent, is totally fouled up?

I mean, there always has to be some symmetry about these things. You cannot have an accounting system that's broken down like this, and at the same time, tell the American people that this country's national security can be assured. I mean, that's what I don't get, Mr. Chairman. I mean, we're here and have these hearings all the time. I mean, the real question here is the relationship between the breakdown in accounting and the relationship between this country's ability to defend itself, because, you know, we're selling the American people a phony bill of goods here is what it amounts to. Nobody in the private sector could ever get away with this for too long. Enron proved that. So I'm wondering, to go back to Mr. Friedman, you know, the next panel—is that 10 minutes, Mr. Chairman?

Mr. KUCINICH. I will ask one question here of Mr. Friedman and I thank the Chair. In the next panel, Mr. Franklin Spinney will testify. He's described the Pentagon's financial management crisis involving two fundamental problems. First, the historical books cannot pass routine audits required by law; and second, planning decisions systematically misrepresent the consequences of future decisions.

Mr. Friedman, do you agree that these are two problems the Pentagon currently suffers from? And finally, I would like to read just one section of his testimony and see if you can respond. He says low ball cost estimates breed like metastasizing cancer cells throughout the entire defense program. By its numbers hide the future consequences of current policy decisions permitting too many programs to get stuffed into the outyears of long-range budget planning. This sets the stage for an affordable budget bow waves repeating costs and cycles of cost growth and procurement stretchouts decreasing weights of modernization in older weapons, shrinking forces and continuing pressure to bail out the self destructing modernization program by robbing the readiness accounts.

Mr. FRIEDMAN. As far as the historical books, I think that's self evident because they have not gotten—they have not been able to get a clean audit opinion and a clean audit opinion is not readily on the horizon. I am not sure—the last comment he made is beyond the purview of our group.

Mr. KUCINICH. I thank the Chair for this extra time period. Thank you.

Mr. SHAYS. I am just trying to count the matrix. Mr. Tierney. Excuse me, if you would just be able to tell me, I have two different charts here. Why would I have more than one chart?

Ms. JONAS. One of them may be more updated, and I think probably the one with the additional systems on it——

Mr. SHAYS. Can I tell you, I tell my staff to do this, but I would always put dates on it. There's no date.

Ms. JONAS. Certainly.

Mr. SHAYS. OK.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. The—you know, this is more than a little bit disturbing, but it's not the first time we've been around this block, so I suppose we shouldn't be surprised.

Let me just—first of all, there was an insinuation that one of the things that works in industry is competition. So, Mr. Friedman, let me ask you, what is going to replace competition as the driving motivational factor in the Department of Defense in moving toward this reform?

Mr. FRIEDMAN. Well, for one thing, as numbers improve and as the Secretary and his senior people are given good metrics, they're going to be able to measure—they will be able to measure things and determine, this is how well you've done this particular function today; now let's see you do it better down the road.

Another thing—and this is something our committee felt—the incentives to managers in the Defense Department were really very different than the private sector. If you looked at a manager's incentives, he hasn't gotten any material bonus for doing a better work. It's hard to measure whether he's, in fact, done better work. It's very hard for him to discharge an employee that he considers to be incompetent; and at the end, when he looks at it, there aren't the incentives to really stick his neck out and do anything other than manage the budget. So we think that should be changed.

I think that the—I think that there are various processes for comparing to the private sector and making clear comparisons of cost effectiveness there, and those should be utilized. So there are

plenty of ways to stimulate this, but the overarching one that people constantly came back to is, there must be continuity in this effort.

If people there in the Defense Department believe this is the flavor of the month and that their bosses are going to be leaving in whatever the actuarially measurable time is, a year and a half for senior people and then this will not be a continuing priority, you will not have the sustained effort. On the contrary, if you enforce the continuity, hopefully you won't be asking the same questions of someone in my seat 6 or 8 years from now.

Mr. TIERNEY. Well, hopefully. I mean, I just looked at Secretary Rumsfeld and Deputy Secretary Wolfowitz. They've been around this game before. They are some of the people coming back into the cycle. So they've had one bite of the apple years ago; and here we are coming back a second time, and we're still dealing with the same issues here.

Tell me, you know, to the extent that you talk about pay scales or incentives like that to attract, in the military, I mean, you have promotion or no promotion. You don't think that's adequate enough, the pay scale increases or changes that go with that? Isn't that the structure militarily, you reward it that way?

Mr. FRIEDMAN. We consistently heard, as a criticism of the ability to perform and get where we all want to get, the fact that pay scales have fallen sharply behind the private sector, that the Department does not have the skill sets that it needs to accommodate to what is modern in the 21st century, that people were trained in many systems that we're trying to move away from, and that we need more advanced-degree professionals, more people who are trained in business practices; and so I—we came to believe that change was needed there.

We did not have time to study the IRS. My understanding is that some real ability to break pay scales was afforded to Commissioner Rossotti, and I think one thing that ought to be explored is bringing in midcareer professional experts to work, people who don't plan to work for retirement, but as a matter of patriotism and other things, would like to try to work on this problem.

Mr. TIERNEY. Mr. Lanzillotta, what is the Department doing in that respect?

Mr. LANZILLOTTA. Civilian reform, civilian pay table reform and military pay table reform has been under way for a long time. Dr. Chu last year, or 2 years ago, started on the military pay table reform and tried to target these—on the military these midtermers to try to get them to stay so the Department doesn't lose their expertise.

I will agree that on the civilian side we have to do more. As the latest example, yesterday crossed my desk a lieutenant colonel that was getting out, and we wanted to have him stay on board and hire him. He had an offer that he delivered to us from another corporation to sit down there, and they are willing to pay to him more than I'm being paid, you know. So to give him an adequate compensation or a comparable package, we'd have had to bring him on at the SES–3 level.

Mr. TIERNEY. It's sort of ironic, isn't it, that this individual is involved with a system that looks like this, and yet private industry,

which we think is part of the solution, is going to hire him. I don't get it.

Mr. LANZILLOTTA. There are—you know, there isn't one person individually that's responsible for——

Mr. TIERNEY. Oh, no. I think it takes a whole peck of people to——

Mr. LANZILLOTTA. We are trying now to come over there and put in overarching architecture and put some order to this. This isn't really a statement or a solution, but this is really a statement of the problem—of the complexity of the problem that we're dealing with. You know, what we hope to do with the architecture that we're putting into place is, next time we come over here, we can show you a mapping of the systems that are much more orderly and do provide that management information. The Department is trying to get there as soon as they can.

Mr. TIERNEY. Let me ask you, when is the next time we should invite you over to get that then, because I'm looking here, and I notice that back in 1998, the Inspector General told us that this would all be set and ready to go in 2003, and here we are and we're not ready yet. So could you give me just a rough idea of when you think it is that you'd be able to come back to us with a more understandable chart and some ideas of where we ought to go with this thing?

Mr. LANZILLOTTA. Well, we're at the will of the committee. I mean, when the committee wants to have us come over for any type of——

Mr. TIERNEY. I don't want to bring you back for no reason. They told us back in 1998, the Department of Defense remains unable to comply with the various laws requiring auditable financial statements; the Department hopes to complete the fielding of systems capable of complying with Federal accounting standards by fiscal year 2003.

So I guess my question to you is, it's 2003, and obviously we're not there yet. When can we expect to have systems capable of complying with Federal law?

Mr. LANZILLOTTA. In April 2003 we're going to produce the blueprint. In 2003, we'll begin prototyping and testing of the solution. In 2005, we'll deploy—or start to deploy the Department-wide solution from the architecture. Any of those dates that the committee would want us to come back, we'd certainly be willing to do.

Mr. TIERNEY. The other question—I still have some more time. The other question I had was, Mr. Friedman indicated that one of the issues was a readier ability to discharge weak performers. Do you have any report to us as to what is being done about that issue or what you need in order to be able to address that issue?

Mr. LANZILLOTTA. I'm probably not the right person to ask that question to. I really haven't studied what options are available. We recently went out with the task force and informed the commanders of the various options that are available, both military and civilian, to address weak performers, and they include a wide variety of tools. I just don't really feel qualified to——

Mr. TIERNEY. Who would be able to tell us that, because I'm curious if these people aren't performing, why—particularly in a mili-

tary environment—they haven't been shuffled someplace else to do something they aren't qualified to do?

Mr. LANZILLOTTA. I don't want to leave you with the misperception that we have willing nonperformers out there that we know about that——

Mr. TIERNEY. I'm not saying it's willful or anything. It's just that in private industry that I'll familiar with in over 20 years, if somebody can't do the job, you find another place for them, and I'd like to know who would tell me in this organization, Department of Defense, whether that is being done or to what extent it is being done; and why it's not being done, if it's not being done, and what's going to be done about that fact?

Mr. LANZILLOTTA. Well, that falls within Personnel and Readiness. I can't give you any facts. I have no facts today that I could give you as to where we stand on that.

I could provide something for the record if——

Mr. TIERNEY. No, no. You've given me the people that we need talk to. That's all.

Mr. Friedman, what is the extent of that problem as it impacts this situation that you outlined?

Mr. FRIEDMAN. Well, I will just—I'll just pass on something anecdotal.

Talking to someone in the personnel area that asked the question, let's assume you have an individual who's in the bottom 5 percent of your performance group and who is just believed to be incompetent at doing this. How long would it take—to use your phrase, "segue that person" into doing something—something else outside of the Department?

I was told that in perhaps the best circumstance, it might take a year; when in other circumstances it might take, I was told, 18 months. I was given a very—when I asked how much time it would take of the supervisor's time to effect that departure, I honestly forget the amount of time, but it was at least a month spread out over that year or 18 months with panels, reviews, et cetera; and what I was told was that for practical purposes, therefore, it's just not a useful expenditure of a supervisor's time, because that supervisor would just be spending an unacceptable amount of their time working with that individual. So they will try to do what they can to transfer them and——

Mr. TIERNEY. How much—as a percentage of the work force that is involved in this process that we're talking about, how many—or how much of a percentage of those people do you think fall in the category of not meeting the mark, not being up to the job?

Mr. FRIEDMAN. I think that's an exceedingly pertinent question, because enterprises are about people and culture. I don't believe that anyone can give you an answer to that question, because my impression is that you do not have the personnel review processes in place to make those tough judgments on people and then to mentor them.

It's not just about firing people. It's about trying to develop a personal development plan, which is part of what I meant by a human capital strategy.

Mr. TIERNEY. So it sounds to me, Mr. Chairman, that if we want to followup on this, some of the people we want to talk to might

be the personnel people, because they seem to be a part—a significant part of this issue.

But I know my time is up. Thank you for that.

Mr. SHAYS. We'll have a second round here.

Starting my first round of questions, the—this is the most up-to-date chart here?

Ms. JONAS. That's correct.

Mr. SHAYS. But that chart is different from this chart and different than this chart. So, you know, it's just not, frankly—I mean, it does illustrate some, but it just—it just would have been nice to have an up-to-date chart if this is the chart you want to show us and not show us these; and it just strikes me that this chart won't be up to date next week. And I don't criticize you for that, but it won't be. There will be something within one of those blocks that you'll realize there is another element of something.

Ms. JONAS. Mr. Chairman, this is a living data base, and it is astounding, because I think at the beginning of this year, we started—our notion was about 600-some-odd systems. So I apologize for the lack of dates on the documentation, but it is a weekly——

Mr. SHAYS. Well, I know—and because of that, that's why you need the dates, that's all, because it's just going to constantly change. And in one of them, you see a tremendous amount of interaction in a core right around here, and in another one, you see just a tremendous amount of activity along a band.

This, to me, is probably the best explanation of why we haven't succeeded in the past, but it—I'm just trying to—we've had eight hearings on this. Mr. Horn has had countless hearings on this issue, another subcommittee dealing with financial management, on all different government agencies. The fact that we know that the failure to be able to audit any account—any part of it, you have a tremendous amount of inefficiencies.

You have a misuse of resources. You are buying things that you don't need and destroying things you may need and storing things you don't need, even within an inventory. We learned in other parts of the hearing, we had a contaminated mask—they weren't contaminated; they just didn't function—and they stuck the masks in with their other inventory, and then couldn't track which ones were the bad masks. So in a sense, then, all the masks came into question.

So we—I'm going to add something else. This would put people's lives in danger.

I mean, every element of this is—just cries out for a solution, and the—I made a point, under the Clinton administration, of not blaming them for this, because there was a Bush administration before there was a Clinton administration, et cetera, et cetera.

And I'm just eager to know from you, Mr. Friedman—I'm not clear, as I want to be, as to why we didn't have really any success. I mean, we have had no success. Is that accurate?

Mr. FRIEDMAN. I can't measure precisely how things stood in 2001 as versus 3 years earlier or 6 years earlier. I think that there probably were some successes along the way. When you—when we spend time talking to numerous people, there were definitely areas in which people had made progress.

This was not a situation in which we felt people didn't care about good financial management. This wasn't people being slothful. It was essentially the lack of—the lack of the tools and the lack of the skill sets and the lack of the high priority; and I think some of the—some of the successes were then dwarfed by the complexities of new issues that came up. This was what I meant earlier when I said that absent an authoritative plan, i.e., one that had teeth and that was enforced with the power of the SecDef behind it, new issues of nonstandardization were constantly arising. So, to me, it's almost like the legend of the fellow pushing the huge boulder up the hill. He'll make progress and then he'll hit something and then it will come down a ways.

Mr. SHAYS. Well, let me ask you, when you say there's successes, do I take one of those blocks and say someone was empowered to fix their system and they fixed it, but it didn't interface with the rest of the system? Is that basically kind of—Ms. Jonas—Ms. Jonas, let me ask you, is this your responsibility primarily?

Ms. JONAS. The development of this program, the financial management modernization program and the enterprise architecture which will be delivered in 2003, the six prototype sites that we'll do in 2004 and our implementation is my day-to-day responsibility.

Mr. SHAYS. Mr. Lanzillotta, do you have the authority to go to any unit within any of the branches and basically say this has got to change?

Mr. LANZILLOTTA. Dr. Zakheim does have that authority, under the CFO act.

Mr. SHAYS. Who does?

Mr. LANZILLOTTA. Dr. Zakheim, my boss, does have that authority to go through, and he has issued out a lot of policy guidance, and we can provide that for the record to the services about the steps we've taken.

Just to clarify a point, sir, on your last question to Mr. Friedman, I think the problem—there was two approaches that were taken to try to improve financial management in the Department. The last approach, that it's such a huge and dynamic problem as we've outlined here, that the previous administrations, both Republican and Democrat, decided to try to take it in small pieces, they decided to look at environmental liability to see if they couldn't advance the ball in one area—what became, you know, apparent through Mr. Friedman's study.

And as we looked at this problem, the small pieces, trying to bring the small pieces together wasn't going to work. There had to be an overarching architecture or plan that people were marching to, although it is much easier to take a bite of the apple one at a time.

Mr. SHAYS. I mean, I don't know why they're mutually exclusive. I mean, it would seem to me he would be doing this, he would be breaking it up into little parts, he would be doing all of the above.

Mr. LANZILLOTTA. They are not mutually exclusive, you're right, sir, but what was missing was the overall plan, the overall architecture, of where they were trying to get to; that wasn't there. And so, when an individual program manager was trying to develop the standards and get his system fielded, you know, he didn't have the standards, the overarching plan, of what he was trying to do.

Mr. SHAYS. Let me ask you, though, if I had someone from the previous administration or the one before that administration—I mean, this committee has—I've been here 16 years, or 15 years, and I'm trying to—I'm trying to think of what, you know, they told us. What they told us seemed to make sense, and you know, I felt they had an overall plan. I mean, they wouldn't—I don't think they would agree that they didn't have an overall plan.

Mr. LANZILLOTTA. What I meant in overall plan, you know, previous administrations had a financial management improvement plan where they laid out—tried to lay out a concept of operation of how they were going to do it; but the enterprise architecture, there was never a blueprint for what the systems were to look like. There was never a blueprint for, you know, what it is we were trying to accomplish departmental-wide.

When you look at the payment of contracts, you know, how many systems were involved in the payment of contracts, and where we lose the auditability is not that we can't account for the money, but as these systems don't interface properly and it takes manual input, then that's when you have to go back and verify every entry all over again; and it's a problem of interfacing in the systems. And so that's the part that was missing.

Mr. SHAYS. OK. You know, I've been—I looked at one of the questions that staff has prepared, and they gave me an opening statement about it. It said DOD's fiscal year 2003 technology IT budget request is over $26 billion, and I leaned over to Vinny, and I said, Vinny, you don't need $26 billion. You know, you don't need $26 billion.

And the reason—I just came back from Russia. They're spending $7 billion for their entire budget. Now, admittedly, their whole defense structure now is nuclear. I mean, it's—I say "whole." I mean, their ships don't go out to sea. Their armies don't use live ammunition. Their planes don't fly. And—but we're talking just—is that accurate, $26 billion?

Ms. JONAS. I can certainly provide that for the record, but that sounds about right to me. I know it was——

Mr. SHAYS. It just astounds me. I mean—and, you know, we're being asked—I've voted for the defense budget over a number of years. I voted against them in part because I didn't think I should support a defense budget that you couldn't audit.

Now, I just felt like it was too hard for me to—I didn't think I could support a defense budget where we don't ask the Europeans to pay more and that we haven't used it to have a more rapid deployed military. I mean, we can't use our—our Special Forces are being overworked right now and so on. So, I mean, there were a lot of reasons.

And now I voted for it because we're at war, and I'm saying I'm not going to look a military person in the eye and say I voted against their budget. But I guess just saying to you that—I'm going to have a second round of questions—we've spent billions of dollars on information systems. Are you telling me that those information systems weren't able to interact with each other?

Ms. JONAS. Certainly this schematic shows that there are big problems.

Mr. SHAYS. No, no. That doesn't show whether—all of these could interact. That doesn't show that they can't interact.

Ms. JONAS. Not in an efficient fashion, Mr. Chairman.

Mr. SHAYS. One of the other things that this doesn't do, among other things, it doesn't show me weights. One of those blocks could be huge compared to the others. So, I mean, I think you're going to have some fun really figuring out how you're going to make this even be, you know, more helpful to you.

You're not looking at the right chart, if you're going to ask—that's even a different one than I have.

Mr. KUCINICH. Actually, Mr. Chairman——

Mr. SHAYS. That's mine?

Mr. KUCINICH. No. This is not yours. This is a different one than you have. Do you have the——

Mr. SHAYS. Yeah. I have two others. Let me just see if that's—yeah, that's the same.

Mr. KUCINICH. Actually, is it my turn?

Mr. SHAYS. Yeah, you've got it.

Mr. KUCINICH. Thank you, Mr. Chairman.

You know, I've actually been studying this very carefully, and what I've found out, Mr. Chairman, that this, while it appears to be a study of the various financial transaction systems of the Department of Defense, if you'll look at this closely, you'll really study it—I think you've seen it before—it's actually a test for color blindness, and if you study it even closer and you're not color-blind, you'll see that the pattern of these boxes that are green spell out the word "sucker."

Look at it closely. You'll see it. I'm absolutely positive that if you're not color-blind, you'll see that word show up very clearly.

The Inspector General found that in fiscal year 2000 alone, $1.2 trillion in department-level accounting entries were unsupported because of documentation problems, or improper because the entries were illogical or did not follow generally accepted accounting principles.

Does anyone here on the panel have any background in law enforcement at all? Well, I'm going to ask Mr. Zakheim's direct representative, isn't such an environment wide open for possibilities of theft and fraud and embezzlement and things like that?

Mr. LANZILLOTTA. There's a difference. Of course, fraud is never tolerated. You know, the threshold for fraud is zero, and when we find that out, I mean, we take the steps necessary to address that. Unsupported transactions in themselves, you know, that's a different story. That's not necessarily fraud.

You know, I can't go over here and testify to $1.3 billion worth of unsupported adjustments. Unsupported adjustments in themselves are not——

Mr. KUCINICH. Could I ask you this question? How would you know—if you can't audit your books, how would you even know if it was fraud?

Well, I'll ask another question. I don't want to trouble you with that one.

The Department of Defense, according to this GAO report, the latest update in January 2001—is that the latest? Yeah. In 2001, they list 22 areas of high-risk operations, and one of things they

say, the Department of Defense cannot properly account for and report on its weapons—weapons systems and support equipment. They also say, the Army did not know the extent to which shipped inventory had been lost or stolen because of weaknesses in its inventory control procedures and financial management practices. They also say, the Navy was unable to account for more than $3 billion worth of inventory being shipped, including some classified and sensitive items.

What's the possibility that materiel, paid for by the American taxpayers, is ending up in the hands of groups that may not be particularly friendly to the United States of America? Do you know what the possibility is? And in this kind of accounting system, isn't it quite possible that you could have all kinds of military equipment ending up in the hands of people who are not authorized to have such equipment?

Mr. LANZILLOTTA. In the—sir, in the realm of the possibility, you know, I can never give a certification to this for sure. I know of no incident where that's ever occurred or it's ever been brought to my attention——

Mr. KUCINICH. But if you can't audit it and you can't account for it, you don't know where it's going. Isn't that fact?

Mr. LANZILLOTTA. We are caught in a situation of—we understand the problem. What we're charged with is trying to fix it.

Mr. KUCINICH. But wait a minute. I just want to make this point, that the administration has declared that fighting terrorism is the most important thing in this country right now. An additional $50 billion has been appropriated. There's a total of $400 billion for the Department of Defense. By the year 2007, that's going to exceed 50 percent of all of our discretionary spending, and if what we're concerned about is terrorism, wouldn't it be the highest priority to get this accounting system straightened out so that—you don't know—here it says, "can't account for and report on weapons systems, do not know the extent to which shipped inventory has been lost or stolen, unable to account," with the Navy, "for more than $3 billion worth of inventory being shipped."

You don't know. I mean, admit it, you do not know, and in that environment it becomes critical as a matter of national security to get a handle on this accounting system. You don't know where the weapons are going. You don't know if the United States has them in their hands or if somebody else has it. We've got this huge military machine, and we have no control over it whatsoever. It has a life of its own, and it's losing all kinds of materiel, and you don't know where it is; and you want to hope that it's not in the wrong hands, but you cannot guarantee the American people it's not in the wrong hands.

And yet our whole budget is aimed at making sure that we defend this country. What a crazy, screwed-up system.

Mr. SHAYS. Mr. Tierney.

Mr. TIERNEY. Let me just talk for a second. I notice that, a while back, the corporate information management program in the late 1980's was attempted, and after about 8 years and $20 billion, that whole effort was abandoned. And one of the reasons that the GAO, General Accounting Office, said it was abandoned was that there was resistance between the Department of Defense components

and a lack of sustained commitment to the program. It said some military departments did not want to participate in this corporate information management, believing their financial management systems were superior to those that were being proposed by the CIM.

Do you still, Mr. Lanzillotta, see—or Mr. Friedman, or both of you, do you still see that kind of intransigence or misbehavior, I guess I would call it, on the part of people in the different branches?

Mr. LANZILLOTTA. I believe now that the moons are all aligned. We have the highest support for fixing financial management than I think the Department has ever had. I think that there's no daylight between the Secretary of Defense's position and each of the service secretaries.

I understand that there were—before that, there weren't—that couldn't necessarily be said. Improvement of the financial management systems, the management information systems, is one of the Secretary's highest priorities. The priority is there. I think that this fell for different reasons, but I'll take the GAO's comments.

Mr. TIERNEY. Well, just stepping away from the Secretary for a second, because I don't think we're here to beat up on any particular Secretary over the last 30 years or whatever, but I'm really talking about the idea of, is there one force or one branch—let me ask Mr. Friedman.

In your study, did you see the one branch or one force or one group of officers, without naming names or anything, that was more intransigent on these issues than others? Is there one section of the service that we have to be more concerned about?

Mr. FRIEDMAN. We didn't have a sense of that, sir. The notion that people would think their own way of doing things is better is not unique to DOD. It exists in every stovepipe bureaucracy I've seen, and it certainly exists in business enterprises.

The answer to it, the cure to it is, there has to be an empowered individual, whether it's the CIO, the CFO, whoever, the chief executive officer says he is going to ensure standardization; and the phrase they use in the Pentagon is, it has to have finger-in-the-chest urgency. It's got to be one of the high priorities.

I think a very interesting point is that the Defense Department actually did get the job done in Y2K. There was—our interviews indicated there was a clear understanding that this was a crisis that had to be faced. It had a high priority. People were brought together, and there was centralized decisionmaking that there couldn't be leniency of figure out your way of doing it. So it can get done.

Mr. TIERNEY. I guess it's a good point. I would expect then, in that case, people who got promoted and people who got demoted and people who went up and down based on how well they were responding to that Y2K problem—and it brings me back to my earlier issue which we can't solve here—is why that doesn't happen to people that don't do their job now. I think that's probably the whole of the hearing.

Mr. Friedman, you did mention that you need more commercial-like practices for the private sector, partnering of activities which

are not inherently governmental. Can you expand on that concept a little for us, give us some examples?

Mr. FRIEDMAN. Sure. If you look at the private sector, you will see that very imminent enterprises—General Motors outsources billions and billions of dollars of its annual processing for accounts payable, accounts receivable, payroll; Microsoft outsources much of it financial and accounting; PriceWaterhouse, Travel Systems, BP Amoco, on and on and on, there is a—my understanding is, there is a government target to do more of this. The processes for doing this, if you read the report that was prepared by a panel led by the Comptroller General of the United States, the processes for doing this are—"convoluted" would be an understatement, and this, we were told by individual after individual, acts as a deterrent to effectively getting private sector partnering done; and it means that when it is done, it is a long and laborious time period.

I know that is an issue of some controversy. It was an issue of some controversy on the Comptroller General of the United States panel. But that is what the private sector is doing, and it's got to be determined at a pay grade above mine as to whether that's something that should be made more efficient.

Mr. TIERNEY. You've certainly got all the jargon down, pay grade above yours——

Mr. FRIEDMAN. Oh, yeah.

Mr. TIERNEY. You've learned something going the other way. Are those statutory impediments to your knowledge, or are they regulatory or just——

Mr. FRIEDMAN. My understanding is that it is—it is an OMB circular, A–76, that governs this, and I think the Department has recommended various changes. The Comptroller General has panel-recommended certain changes. It was beyond our purview to look into this in detail, but we looked at it enough to recognize that this was—this was an issue.

Mr. TIERNEY. Thank you.

Mr. SHAYS. Thank you. I would just—just a few questions here. The—going with the $26 billion request for IT, whether it's 26 or 24—how do we feel assured that it's going to be spent in a wise way, given the mess you've got to deal with?

Mr. LANZILLOTTA. Mr. Chairman, requirements are out there, and they're determined without—you know, without the use—we know what the requirements are, and when we determine the budget, we know what the requirements are. Like when we built the architecture in the contract, we went out and received outside input, and we got requirements that were developed, and we knew how much this architecture to develop was going to cost us——

Mr. SHAYS. I'm not understanding a bit of what you're saying to me right now. I don't know how that's an answer to my question.

You're saying—you have built this incredible case that makes me understand that the task is unbelievably difficult and challenging, and that we've got an 8-year plan. And you don't have the plan in place, correct? Because this is really the way it is, not the way it should be.

Is that right, Ms. Jonas?

Ms. JONAS. Mr. Chairman, we do have a plan——

Mr. SHAYS. No. That's not the question I asked. Is this the—is this the example of what exists today or what you want——

Ms. JONAS. That is correct. This is the current state of our environment.

Mr. SHAYS. OK. Now, do you have another graph of a chart that shows me what you want the world to be like?

Ms. JONAS. A month ago an award was given to IBM to come in to develop what we've been talking about——

Mr. SHAYS. The answer would be no, correct?

Ms. JONAS. That is something that is part of——

Mr. SHAYS. I don't—this is the—you answer my question, and then I'm happy to let you expand or put these—this isn't a trick. This is—we want the committee to know what we need to know, and you have the information to share with us.

But I want the answer first: Do you have a plan in place, as we speak, that would—you could put side—you know, alongside this and say, this is the way we want the world to look?

Ms. JONAS. We do not know what we want the world to look like. We do not have that, sir.

Mr. SHAYS. OK. But what else did you want me to know?

Ms. JONAS. The point of the development of an enterprise architecture which will be delivered over the course of the next year does have specific milestones and delivery points. For example, what we're asking our contractor to develop for us is—after this as-is development is made, what is a transition plan, and what should we look like in the future. That—that entire process will be completed within 1 year.

Mr. SHAYS. Yeah. It just strikes me, though, that $26 billion is so much money. I mean, obviously I guess some of it is just a machine that gets your paychecks out. So some of this is—but it's still $26 billion, and Russia's budget is $7 billion, and so I'm just concerned.

Have you developed metrics that Congress can use to assess your progress, and do you have the ability to assess your own progress here?

Ms. JONAS. Yes—the answer to that is yes. We do have internal metrics. We have deliverables at specific timeframes within this year. The first—we're on schedule and had a first deliverable Sunday of last week. We will have another deliverable in 90 days. We would be very happy to share that with the committee.

Mr. SHAYS. And describe to me what you mean by a "deliverable."

Ms. JONAS. The contractor is expected—as part of this 30-day—or task delivery, they're supposed to tell us exactly how they will manage their work over the next year. So, for example, because we were able to get so much work on an as-is environment done during the time we were waiting for our appropriation, much of the work that the contractor will be embarking on is business process reengineering.

In other words, it is apparent to the committee that this is completely inefficient. It is way too complex. We do spend too much money. So how do we refocus, reengineer our processes that will create some efficiency and will be able to allow us to——

Mr. SHAYS. The question of how you do that, and it's the question of what you're doing right now that I have a question about.

Describe to me one of those icons, and tell me—pick a simple one, and pick a really difficult one in there. Just—you know, in other words, if you just went up to the board and you said, this one here represents, you know, this mammoth undertaking in which three branches are connecting here, to one that's very simple. In other words——

Ms. JONAS. Well, for example, the brown icons represent inventory systems. So we are working with the Acquisition and Technology folks, headed by Secretary Aldridge, to integrate those systems into an enterprise architecture.

Mr. SHAYS. So you're basically—you're going to be able to say, DOD-wide, that you want an information system that can interface with each other and tell you the same information?

Ms. JONAS. That's correct.

Mr. SHAYS. OK.

Now, that, I would think, you would have done before you came. I mean, that isn't—I'm making the assumption that was being set up. That was not a goal of the——

Ms. JONAS. Not to my knowledge, Mr. Chairman.

Mr. SHAYS. You know, the sad thing is, we're losing Mr. Horn; and Mr. Horn, when we talked about 2002—excuse me, the year 2000—he would meet with each department. He would grade each department, and he was a—we found that he was a real stimulus for some action among the—I just—you know, this committee spends a lot of its time now on terrorist issues, and I hope we have a committee that's going to be really pushing you all.

Before we close, just so—because you're going to come back sometime again soon—I want you to pick one of these—was the inventory one a simple one? That seems to me to be fairly simple.

Ms. JONAS. That's simple or, for example, the personnel and payroll systems.

Mr. SHAYS. OK.

Ms. JONAS. Let's see here. Do I have this on here?

Mr. SHAYS. Yeah. On the top left.

Ms. JONAS. Yeah. That's an area where we think we can get some real efficiency. There are—excuse me.

We understand that there are over 102 personnel in payroll systems here. Clearly, this is inefficient; and so we're working with Dr. Chu's organization, which is the——

The CHAIRMAN. So I would see 102 up in that board if I wanted to count to green?

Ms. JONAS. Yes.

Mr. SHAYS. What I'm still asking though is to show me one of those icons that really represents your most challenging effort.

Ms. JONAS. Well, of course—I mean, I think they're equally challenging. Our——

Mr. SHAYS. Not every one of these has the same weight. They don't. Even within the colors, they don't have the same weight.

Ms. JONAS. Well, the bulk of the ones in the center are——

Mr. SHAYS. For instance, is the payroll in the Army going to be more difficult than the payroll in the Department of—in the Navy? Is there one that you just look at and you say, "Good grief?"

Ms. JONAS. We say "good grief" a lot, Mr. Chairman. I can't today say specifically which one I would say——

Mr. SHAYS. OK. I just will reiterate.

It seems to me you're still trying to understand the problem, and so anything you're doing right now is a hope and a prayer, maybe a little bit more, that it will fit into this overall plan, which isn't yet developed, and yet we're still spending a tidy sum of money each year with IT, for instance.

So, any comment you want to make?

Mr. LANZILLOTTA. Mr. Chairman, I just want to clear one misperception.

The $26 billion also includes Command and Control IT systems that are devoted toward weapons systems and aren't necessarily even a part of this problem. It could be the digitization between an F–15 or an F–16 and a tank.

Mr. SHAYS. Well, that's a very important point. So what is that $26 billion?

Mr. LANZILLOTTA. That represents the total——

Mr. SHAYS. I understand. So what should—what should the number be as it relates to this issue?

Ms. JONAS. Mr. Chairman, our current estimate for what we're spending over the 5-year plan is between $4 and $5 billion.

Mr. SHAYS. No. And that's for—does that include someone getting out the payroll?

Ms. JONAS. Yes.

Mr. SHAYS. OK. It's $4 and $5 billion.

Well, we could go a long time. We have another panel. Shall we get to the next panel? Yeah.

Are there any closing comments that any of you want to make?

Ms. JONAS. Thank you, Mr. Chairman. We appreciate the opportunity to be here.

Mr. SHAYS. Well, we like—I'm sorry. Thank you for saying that.

We would like to play a positive role in this. I think my colleague's frustration is that we're spending so much money now for—our budget is gigantic. It's crowding out other important issues, and it just seems like we've really run out of time. And so it's kind of on your watch, and I think my frustration—and I don't use that word often—is that I had the sense Secretary Rumsfeld was—this was going to be his highest priority.

And it's not his highest priority now, it's the war on terrorism; and I'm just hopeful that you all still feel empowered to take decisive action.

I'm going to make an assumption, unless you tell me differently, that you have all the power—your office has all the power necessary to make any change you need to make. Is that accurate?

Mr. LANZILLOTTA. The CFO has that power.

Mr. SHAYS. OK. So that won't be an excuse.

OK, thank you very much. Appreciate it a great deal.

Can you all just stay a second more, because my staff is just—just please sit down a second. I'm sorry. When you say you have all the power, I would just like my staff to ask this question.

Mr. CHASE. When you said that the Comptroller has all the authority to implement this system, does the Comptroller control—or does he control the purse strings that would allow, as an example,

the Department of the Air Force, to go forward and purchase or develop a new system?

Mr. LANZILLOTTA. I'll have Kenny expand on that. The Comptroller has issued several memorandums and guidance that deal expressly with that issue. The Secretary has delegated the authority necessary for Dr. Zakheim to carry out this mission. All ultimate authority rests with the Secretary, and maybe that could explain it. She has more detail on the memorandums that have been issued.

Ms. JONAS. One important policy memorandum that Dr. Zakheim has issued over the last year is the ability to stop the development of systems. We are doing reviews on many of the systems on this board, including meaning many Navy systems, defense logistic systems, and that is quite a bit of a change. He is frequently using his ability to hold up reprogrammings, if necessary, to do what it takes, using the budget as a little bit of a hammer to get the right incentives to the system.

Mr. TIERNEY. Just one followup on that.

What would Congress do if it wanted to incentivize prompt action and capable action on this that wouldn't interfere with our defense mechanisms, but would give somebody a real sting to know they'd better get this done?

Ms. JONAS. We've actually received, Mr. Tierney, a lot of support from Congress. The Senate acted last year to help us on the arresting of many of these systems. We've gotten support from the House in this regard. If we may reserve some—that opportunity, I might get back to you, but I think right now we've gotten substantial support from the Congress.

Mr. TIERNEY. But it seems to me that we just keep feeding the beast, and cross your fingers. I think that's, you know, not something I'd feel comfortable doing.

At what point do we stop giving billions and billions and billions of dollars every year to this group without saying, hey, we're taking some chunk of that away from you until we see that you deserve it? And what is it that we'd take away that wouldn't hurt our defense posture, but would certainly give people a good kick in the can?

Ms. JONAS. Well, certainly with respect to what we're doing in the financial management modernization program, we are stopping spending on certain systems.

Mr. TIERNEY. Can you followup and put that information into the record as to which system you're stopping and——

Ms. JONAS. Absolutely. Yes, indeed.

For example, I mean, some of the Navy pilot programs and enterprise resource planning programs are—we've arrested the development on those.

I'd be happy to provide that for the record.

Mr. TIERNEY. Any weapons and acquisition programs that you're doing that with?

Ms. JONAS. That's not my purview, but maybe Mr. Lanzillotta can——

Mr. TIERNEY. Mr. Lanzillotta, how about any weapons systems?

Mr. LANZILLOTTA. I'm not sure I understand your question, sir. Are you talking about Crusader?

Mr. TIERNEY. Well, we just said this—they take away the name tag and I forget your name; I'm sorry. But they were just saying that they are stopping payment on some systems or some plans in order to get the incentive to move forward, accounting plans or whatever. Are we doing anything with respect to weapons systems that are over budget and behind schedule and otherwise having problems with their accountability to give them the incentive to straighten out?

Mr. LANZILLOTTA. We have several of those systems that just certified to Congress on the Nunn-McCurdy breaches. There were six of them. The DPG calls for further studies that will be going on this summer on five or six other intensively managed programs that we're looking at.

I'm really outside my realm here to talk about weapons systems. That would be better addressed to the Under Secretary for AT&L.

But the short answer to the question is, yes, we are looking at weapons systems too.

Mr. TIERNEY. Would you followup on the record then with regard to those six and then the five programs that you just spoke about.

Mr. LANZILLOTTA. On the Nunn-McCurdy breaches?

Mr. TIERNEY. Right. And what they are and what's happening with them.

Mr. SHAYS. Thanks to all.

Thank you, Mr. Lieberman. Oh, sorry. We already have our new list out.

We have Joseph Schmitz, Inspector General, Department of Defense, accompanied by Mr. Robert Lieberman, Department of Defense; Mr. Gregory Kutz, Director of Financial Management and Assurance Team, U.S. General Accounting Office, accompanied by Mr. Randolph Hite, Director of Information Technology Systems Issues, General Accounting Office; and Mr. Franklin C. Spinney, Jr., Tactical Air Analyst, Office of Program Analysis and Evaluation, Department of Defense.

If you'd stay standing, I'll swear you in.

[Witnesses sworn.]

Mr. SHAYS. Note for the record, our witnesses have responded in the affirmative.

We're going to get started right away. Mr. Schmitz, you're on.

STATEMENTS OF JOSEPH E. SCHMITZ, INSPECTOR GENERAL, ACCOMPANIED BY ROBERT LIEBERMAN, DEPUTY INSPECTOR GENERAL, DEPARTMENT OF DEFENSE; GREGORY KUTZ, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE TEAM, ACCOMPANIED BY RANDOLPH C. HITE, DIRECTOR, INFORMATION TECHNOLOGY SYSTEMS ISSUES, U.S. GENERAL ACCOUNTING OFFICE; AND FRANKLIN C. SPINNEY, JR., TACTICAL AIR ANALYST, DEPARTMENT OF DEFENSE

Mr. SCHMITZ. Thank you, Chairman Shays and Ranking——

Mr. SHAYS. Your mic is not on.

Mr. SCHMITZ. How about now?

Thank you, Chairman Shays and Ranking Member Kucinich. This is my first appearance before our congressional committee since my Senate confirmation as the Inspector General of the Department of Defense. I'm not an accounting expert, but I am a con-

stitutional expert, and I am a taxpayer; and tax dollar accountability is fundamentally a constitutional issue.

I was very pleased that Ranking Member Kucinich referred to Article I, Section 9, of the Constitution which requires that, "No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and account of the receipts and expenditures of all public money shall be published from time to time."

In layman's terms, to paraphrase a former Congressman from Illinois and now the Secretary of Defense, every dollar the DOD spends was earned by a hard-working American taxpayer. I would only add that every taxpayer is entitled by the Constitution to a full accounting of each dollar spent.

The financial management audits prepared by my office help to fulfill that important constitutional function. Those audits help to inform the Department, the Congress and the American taxpayers. In that regard, I look forward to working with this subcommittee and the other committees of Congress to ensure that the preparation of financial management audits and all Inspector General work products conform to the highest standards of transparency, accuracy and integrity.

I'd be glad to answer any questions about how I plan generally to carry out this commitment.

This morning, however, I'm accompanied by Robert Lieberman, my deputy. Bob has testified many times before this committee, and as the former Assistant Inspector General for Auditing, has a much deeper understanding of the many challenges facing the Department in the area of financial management. Accordingly, I've asked Bob to present his statement and to be available to answer any questions you might have. And with your indulgence, Mr. Chairman, I'd like to now invite Mr. Lieberman to present his testimony.

Mr. SHAYS. Well, let me just say it would be your testimony on his behalf. OK? He's speaking for you, correct?

Mr. SCHMITZ. He's my deputy. That's correct.

Mr. SHAYS. Well, first, let me welcome you. I understand why you wouldn't have a statement, given that you've been here such a short period of time. It's good that you're here.

Mr. Lieberman, if you have a statement, we'd be happy to hear it.

Mr. LIEBERMAN. Good morning, Mr. Chairman, Mr. Kucinich.

Perhaps it appears ironic today, but at one time, the Department of Defense was the leader in adapting new financial management concepts for government agencies. Its planning, programming and budgeting system was widely emulated; and it led the way in computerizing large payroll contractor payment and accounting operations.

Unfortunately, the uncontrolled proliferation of nonstandard systems and processes for performing both finance, and nonfinancial functions eventually created a host of problems now plague managers. Those include an inability to consistently produce either useful day-to-day financial information or commercial-type financial statements on a quarterly, semiannual or even annual basis. The

limited capabilities of current systems create and perpetuate inefficiencies across the spectrum of DOD business activities.

The Chief Financial Officers Act of 1990 and related legislation brought the financial reporting problems of most Federal agencies, including DOD, to light. For over a decade, we have reported that the lack of adequate financial reporting systems and a variety of internal control problems preclude favorable audit opinions on most DOD year-end financial statements.

Strictly in terms of audit opinions on the reliability of DOD's most recent financial statements, unfortunately, I am unable to report progress for the DOD-wide or major component funds since your last hearing on this subject.

As in previous years, we recently issued an unqualified clean opinion for the military retirement fund statements. Disclaimers of opinion were necessary for all other major funds, however, because of serious deficiencies in the reporting systems and other internal control problems. It will be several years until the management initiatives described by your first panel are likely to result in the drastically improved financial reporting that will earn clean audit opinions.

My written statement highlights a sampling of audit reports for the last 12 months. They illustrate the breadth of the DOD financial management challenge which includes needed improvements in day-to-day operations like paying contractors or collecting debts.

Is the Department focused on the challenge? Certainly the senior leadership is. Also, for the first time in the 12 years since the Chief Financial Officers Act was enacted, I believe the executive and legislative branches are on the same page in terms of what needs to be done to transform DOD financial management.

We have long advocated focusing primary attention on the system weaknesses that are at the core of the DOD financial reporting problems. Section 1008 of the Defense Authorization Act for fiscal year 2002 did just that.

Also, by rejecting the notion that any financial statements compiled by special efforts which bypass or override our official accounting systems are worth their high costs or constitute progress, Congress has appropriately insisted on fundamental, not superficial, reform. The initiatives announced by the Department over the past year appear to be highly compatible with the course mandated by section 1008 and clear indicators to transform DOD financial management, not just tinker with it.

In IG reports and testimony in the past several years, we had expressed concern that the cost of the Chief Financial Officers Act compliant effort was unknown, performance measures were lacking. There was no sense of consistently strong leadership, and there was no assurance that managers would get more useful financial information even if year end financial statements received favorable auditable opinions.

The Department is now trying to be responsive to those concerns. We believe that the new effort to establish a comprehensive financial system architecture is a necessary and long overdue step.

There are undeniable risks. Development of the architecture could take much longer than anticipated. The end product might leave numerous unresolved issues, especially about process

changes. The cost to implement the architecture might be prohibitively expensive or the DOD might lack the discipline to stick to its blueprint.

The DOD does not have a good track record for deploying large information systems that fully meet user expectations, conform with applicable standards, stay within budget estimates and meet planned schedules. Nevertheless, we are cautiously optimistic.

The Department has taken a major step forward by finally accepting the premise that the financial improvement effort needs to be treated as a program with all the management controls that a very large program should have. Those include a master plan, well-defined management accountability, full visibility in the budget, regular performance report financing and resources permitting robust audit coverage.

Mr. SHAYS. Let me just interrupt you. You mean we haven't been doing that in the past? I mean, with the other plans, when we had hearings, I thought all of those things were there.

Mr. LIEBERMAN. No, sir, I think the plans were consistently deficient in all of these aspects over the years. We always had a reasonable top-level vision of where we wanted to go, but the details of the implementation were always lacking.

Mr. SHAYS. OK.

Mr. LIEBERMAN. We believe that now DOD is making a good-faith effort to create a stronger management structure for the improvement effort. We look forward to assisting with timely and useful auditable advice as we did during the year 2000 conversion, another huge system challenge that was successfully addressed, as was discussed earlier this morning.

In closing, since I plan to retire from Federal service this summer, I would like to thank you for the courtesies accorded to me over the many years of hearings and other dialog on defense issues. Hearings such as this one today are absolutely essential if all stakeholders in DOD financial management improvement are to remain, as I suggested before, on the same page.

Mr. Tierney, I think your question to the first panel about what can be done to incentivize the Department can be answered in part by saying that congressional hearings like this on a regular basis are enormously helpful in that regard.

That concludes my summary, sir.

Mr. SHAYS. Well, that's a shocker, that you're planning to retire. You didn't get our permission first? You just did it on your own?

You have been before this committee on countless occasions, and you have always been a superb witness, and your service to your country has been pretty extraordinary. So I have to process what you just told me and see if we give you permission to carry it out. We have a lot more power than you realize.

[The prepared statement of Mr. Lieberman follows:]

HOLD FOR RELEASE
EXPECTED 10:00 A.M.
JUNE 4, 2002

STATEMENT

OF

ROBERT J. LIEBERMAN

DEPUTY INSPECTOR GENERAL
OF THE
DEPARTMENT OF DEFENSE

TO THE

SUBCOMMITTEE ON NATIONAL SECURITY,
VETERANS AFFAIRS AND INTERNATIONAL
RELATIONS

HOUSE GOVERNMENT REFORM COMMITTEE

ON

TRANSFORMING DEFENSE FINANCIAL MANAGEMENT:
A STRATEGY FOR CHANGE

JUNE 4, 2002

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to provide the views of the Office of the Inspector General of the Department of Defense on transforming financial management, which surely ranks as one of the Department's most difficult management improvement challenges. I would like to begin by noting the fundamental fiduciary responsibility of the Department of Defense, which is to manage assets purchased with taxpayer dollars effectively and efficiently. Furthermore, Article I, Section 9 of the Constitution of the United States stipulates that "a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." As you know from your numerous hearings on DoD financial management, the Department has had long-standing problems in compiling accurate financial statements.

The Need for Transformation

The Federal Government and Department of Defense have had numerous financial management improvement plans, programs, and goals over the past 50 years. Perhaps it appears ironic today, but in the 1960's the Department was the leader in adapting new financial management concepts for government agencies. Its Planning, Programming and Budgeting System was widely emulated and it led the way in computerizing large payroll, contractor payment and accounting operations during the 1960's and 70's. Unfortunately, the uncontrolled proliferation of nonstandard systems for performing both financial and nonfinancial functions in DoD created a host of problems that now plague managers. Those problems include a lack of integrated information systems that can consistently produce either useful day-to-day fiscal information or commercial type financial statements on a quarterly, semiannual or even annual basis. The limited capabilities of current systems create and perpetuate inefficiencies across the spectrum of DoD business activities.

The Chief Financial Officers Act of 1990 and related legislation brought the financial reporting problems of most Federal agencies, including DoD, to light by requiring Inspector General audits of year-end financial statements. For over a decade, the Office of the Inspector General of the DoD has reported that the lack of adequate financial reporting systems and a variety of internal control problems preclude favorable audit opinions on most DoD year-end financial statements.

Opinions on Financial Statements for FY 2001

In terms of audit opinions on the reliability of DoD's most recent financial statements, I am unable to report progress for the DoD-wide or major component funds. As in previous years, we issued an unqualified (clean) opinion this year for the Military Retirement Fund's statements. Disclaimers of opinion were necessary for all other major funds, however, because of serious deficiencies in the reporting systems and other internal control problems. A few DoD organizations, whose funds are not large enough to require separate reporting to OMB, have achieved favorable audit opinions, but the impact is primarily symbolic.

Other Recent Audit Results

Although the annual audit opinions on year-end financial statements may continue to attract more attention than most individual audit reports, the DoD progress in addressing the specific findings and recommendations in those reports will be a critical factor in how much financial management improvement actually occurs, especially in crucial day-to-day activities like paying bills and collecting debts.

The variety of recent audit findings illustrates the breadth of the DoD financial management challenge.

-- We reported in May 2001 that the Defense Finance and Accounting Service needed to be more efficient and aggressive in collecting debt from large contractors. We identified 148 cases worth $12.6 million where action was needed. The List of Contractors Indebted to the United States, which is a tool used by disbursing officers to offset contractor debts, included numerous invalid debts and other erroneous data that reduced its usefulness. (Report D-2001-114)

-- In June 2001, we reported that DoD had successfully adapted a commercial automated payment system for DoD freight payment purposes. This enabled the Department to move away from untimely, paper-based, poorly controlled and labor intensive processes for 1.25 million payments per year. However, additional measures were warranted to take full advantage of the system's capabilities and achieve optimum streamlining without undue risk of fraud or error. (Report D-2001-148)

-- In August 2001, we reported that the DoD had failed to develop a standardized cost accounting system for managing the life cycle costs of weapon systems. DoD reports that various acquisition reform goals had been met by establishing such a system were wrong. (Report D-2001-164)

-- The DoD agreed with Congress in August 1998 to implement a new policy to decrease the risk of progress payments being charged to the wrong accounts. We reported in September 2001 that implementation had been poorly managed and the new policy was ineffectual. (Report D-2001-188)

-- We reported in November 2001 that DoD financial management systems were not integrated and could not share data without expensive and inefficient crosswalks. Nevertheless, the Department had been moving ahead with the Defense Finance and Accounting Service Corporate Database and other projects, with insufficient assurance that a truly integrated set of systems would result. (Report D-2002-014)

-- The DoD plans to begin the transition from the existing contractor payment system, the archaic Mechanization of Contract Administration Services (MOCAS) system, to the new Defense Procurement Payment System by FY 2003. Full transition should bring significant improvement to DoD contract administration and disbursement activities. To ensure a smooth transition, it is important to close as many contracts that have been completed, but not closed out, as possible. In December 2001, we reported that DoD had a six year backlog of contract closure actions and needed to accelerate the process. In addition, there were weaknesses in the closure procedures, insufficient resources earmarked for the task and untimely contractor input. Cumulatively, these problems increased the risk to an orderly transition. (Report D-2002-027)

-- From FY 1996 through FY 2001, 382 General Accounting Office and DoD audit reports addressed a wide range of management control issues in the DoD Purchase Card Program. The Army and Air Force had particularly thorough internal audit coverage. Those audit results were summarized in a December 2001 Inspector General, DoD, report. Auditors documented numerous instances of misuse of the cards, lack of oversight and accountability, splitting purchases to avoid oversight, failure to segregate duties and inadequate training. (Report D-2002-029)

-- In January 2002, we reported that most DoD components initially had done little to implement the DoD Financial and Feeder Systems Compliance Process, which had been recommended by us in 1999 and was finally inaugurated by the Department in January 2001, to apply the proven management techniques of the Year 2000 conversion program to financial systems improvement. Progress in mapping the flow of financial data and compiling an inventory of systems had been disappointingly slow, despite the fact that such research was supposed to have been done earlier for a variety of reasons, including identification of security vulnerabilities, contingency planning, and systems architecture development. However, major new DoD management initiatives during FY 2001 and the guidance provided by the National Defense Authorization Act for FY 2002 had established the groundwork for a more successful effort. (Report D-2002-044)

-- In March 2002, we reported that the two versions of the Computerized Accounts Payable System, used for Army and Defense agency payments, lacked effective controls to detect and correct improperly supported or erroneous payments to contractors. (Report D-2002-056)

-- In March 2002, we issued two more reports on the use of Government credit cards. The first was a summary of 31 DoD internal audit reports on the DoD Travel Card Program. A wide range of problems, similar to those in the DoD Purchase Card Program, were identified. The report recounts the actions taken by the Under Secretary of Defense (Acquisition, Technology and Logistics) and the Under Secretary of Defense (Comptroller) between June 2001 and early March 2002 to strengthen both the Travel Card and Purchase Card Programs. (Report D-2002-065)

-- The second report on credit cards addressed ways to improve controls in the DoD Purchase Card Program. This report also recounts recent DoD activities to minimize abuse of Government credit card privileges, including new initiatives announced in late March by the Under Secretary of Defense (Comptroller). (Report D-2002-075)

-- We reported last year that DoD personnel offices lacked efficient procedures for transmitting employee elections on payroll withholding to the finance offices and kept poor records. The error rate for insurance and retirement withholdings and agency contributions was

approximately 9 percent. In March 2002, we reported the same problems were persisting and the estimated error rate remained about 9 percent. (Report D-2002-070)

-- In March 2002, we reported that DoD needed to improve its procedures for tracking and collecting recoupments from foreign governments under the NATO Security Investment Program. Specifically, more aggressive action was needed to collect $38.6 million owed by various countries after the U.S. provided upfront financing for construction projects. (Report D-2002-071)

-- In a second report on contract closure efforts related to the phase out of the MOCAS system, we reported in March 2002 on problems with old contracts that were financed from now cancelled appropriations. Nearly 4,000 of those contracts could not be closed because of unpaid invoices. Various DoD organizations had not identified funding to make the payments and prompt payment interest penalties were being incurred. The Department needs to identify up to $97 million in current year funds to pay these bills. (Report D-2002-076)

The full text of these reports is available on-line at www.dodig.osd.mil.

Responding to Congressional Direction

Section 1008 of the National Defense Authorization Act for FY 2002 directs the Inspector General, DoD, to perform only the minimum audit procedures required by auditing standards for year-end financial statements that management acknowledges to be unreliable. The Act also directs us to redirect any audit resources freed up by that limitation to more useful audits, especially in the financial systems improvement area.

We strongly agree with the rationale behind Section 1008. Due to overall resource constraints, it would be impossible to provide audit support in the crucial systems improvement area if we were forced to continue expending resources on labor-intensive audits of convoluted workarounds and poorly documented transactions that currently characterize most major DoD financial statements. We have long advocated focusing primary attention on the system problems that are at the core of the DoD financial reporting problems. By rejecting the notion that financial statements compiled by special efforts, which bypass or override official accounting

systems, are worth their high cost or constitute progress, Section 1008 has reintroduced an appropriate sense of proportion.

DoD Financial Management Initiatives

The initiatives announced by DoD over the past year appear to be highly compatible with the course mandated by Section 1008 and clear indicators of intent to transform DoD financial management, not just tinker with it. In Inspector General reports and testimony over the past several years, we had expressed concerns that the cost of the Chief Financial Officers Act compliance effort was unknown, performance measures were lacking, there was no sense of consistently strong central leadership and there was no assurance that managers would get more useful financial information, even if year-end financial statements eventually received favorable audit opinions. The Department is being responsive to those concerns.

We believe that the effort to establish a comprehensive financial system architecture is a necessary and long overdue step. There are undeniable risks--development of the architecture could take much longer than anticipated, the end product might leave numerous unresolved issues, the cost to implement the architecture might be prohibitively expensive or the DoD might lack the discipline to make system program managers conform to the architecture. The DoD does not have a good track record for deploying large information systems that fully meet user expectations, conform with applicable standards, stay within budget estimates and meet planned schedules. Nevertheless, we are cautiously optimistic. The Department has taken a major step forward by accepting the premise that the financial management improvement effort needs to be treated as a program, with all of the management controls that a very large program should have. Those include a master plan, well defined management accountability, full visibility in the budget, regular performance reporting and robust audit coverage. We believe that the DoD is making a good faith effort to create a strong management structure for the systems improvement effort. We look forward to assisting with timely and useful audit advice, just as we did during the Year 2000 conversion.

Likewise, we welcome the emphasis in the President's Management Initiatives on controlling erroneous payments. The DoD has worked hard to improve the efficiency of its disbursement operations; however, this is

another area where the inadequacy of current systems and delays in fielding replacements are vexing problems. As the Department pursues the goal of greatly improved financial reporting, it must also keep focused on the need for better controls in many facets of its day-to-day finance operations and closely related purchasing activities, such as the use of Government credit cards. Again, these are areas where audit and investigative support are vital. In addition to a steady flow of relevant audit reports, we plan to continue supporting the Department with proactive fraud prevention and detection efforts, as well as aggressive investigation of indications of fraud. To illustrate the fact that those who commit financial crimes against the DoD run considerable risk, I have attached to this statement a list of examples of recently closed Defense Criminal Investigative Service cases on frauds involving the misuse of DoD credit cards.

Again, thank you for soliciting our views on these matters.

Attachment

Examples of Defense Criminal Investigative Service Cases on Credit Card Fraud

- David M. White pled guilty to placing fraudulent charges against 13 Government credit cards. He was sentenced in U.S. District Court, Panama City, Florida, to 18 months incarceration, $262,840 in restitution and other fees and 36 months supervised release.

- John L. Henson, Jr., pled guilty to using a Government credit card to buy a television for personal use. He was terminated from DoD employment and sentenced in Federal Court in the Eastern District of Texas to a $3,000 fine and $1,400 restitution.

- Lionel G. Green pled guilty to a one count criminal information charging him with theft using a Government credit card. He was sentenced in U.S. District Court, Eastern District of Virginia, to 4 months imprisonment, 4 months home detention, 3 years probation and $61,465 in restitution and other fees.

- Jerome D. Phillips pled guilty to conspiracy in a fraudulent scheme involving the misuse of a purchase card while assigned to the Joint Staff Supply Service. He was sentenced in U.S. District Court, Eastern District of Virginia, to serve a jail term of 12 months and one day, 24 months probation, and restitution and other fees of $120,100.

- Johnny L. Bailey, formerly assigned to the Joint Staff Supply Service, pled guilty to conspiracy to defraud the Government using his official purchase card. He was sentenced in U.S. District Court, Eastern District of Virginia, to 2 years probation, restitution and other fees of $70,100 and 6 months of electronic monitoring.

- Tyrone X. Celey, Sr., pled guilty to bribing Joint Staff Supply Service employees to make credit card purchases from his office supplies company. He was sentenced in U.S. District Court, Eastern District of Virginia, to 27 months of incarceration, 36 months of supervised release, and $400,200 in restitution and other fees.

- Former Master Sergeant Bobby Gilchrist, also a figure in the Joint Staff Supply Service case, pled guilty to one count of money laundering, bribery and conspiracy. He conspired with contractors to defraud the DoD by accepting cash payments for making both otherwise legitimate and bogus purchases from them, using his and other employees' credit cards. He was sentenced in U.S. District Court, Eastern District of Virginia, to 41 months in prison, 3 years of supervised release, and $400,300 in restitution and other fees.

- Carla F. Armstrong pled guilty to six counts of theft and other charges related to misuse of her Government credit card. She was sentenced in Federal Court, Southern District of Indiana, to 3 years of supervised probation, including 4 months of home confinement, and $10,945 in restitution and other fees.

- Tommie Ray Briley pled guilty to stealing Government property by using his official credit card to buy hardware items and selling them to a second party for cash. He was sentenced in U.S. District Court, Eastern District of Texas, to 3 years probation and $26,378 in restitution and other fees.

- Quintin A. Swann pled guilty to charges related to fraudulent use of his Government credit card while employed in the Office of the Assistant Secretary of the Army (Financial Management and Comptroller). He was sentenced in U.S. District Court, Eastern District of Virginia, to 14 months imprisonment, 3 years of supervised release and $90,200 in restitution and other fees.

- Susan E. Johnson and James E. Johnson, Navy employees, pled guilty to charges related to the purchase of a motorcycle and other items for their own use, misusing a Government credit card to do so. Susan E. Johnson was sentenced in U.S. District Court, Eastern District of Virginia, to 5 years probation and fines totalling $1,025. James E. Johnson was sentenced to 6 months home confinement, 3 years probation and $13,279 in restitution.

Press releases on indictments, convictions, sentences and civil settlements stemming from Defense Criminal Investigative Service cases are available at www.dodig.osd.mil. Many of these cases are joint efforts with other Federal and DoD law enforcement agencies, as explained in the individual press releases, when applicable.

Mr. SHAYS. Mr. Kutz.

Mr. KUTZ. Mr. Chairman and members of the subcommittee, unlike Mr. Lieberman this is my first time before your subcommittee, so it's a real pleasure for me to be here to discuss DOD financial management which we believe is a very important topic.

The recent success of our forces in Afghanistan has shown once again that, as demonstrated, our military forces are second to none. However, that same level of excellence is not evident in many of DOD's business processes, including the topic of today's hearing, financial management. DOD's financial management problems date back decades, and previous attempts at reform have largely proven unsuccessful.

Problems with financial management at DOD go far beyond its finance and accounting systems, as you saw earlier. This network of business systems was not designed but rather evolved over time into an overly complex and error-prone operation, as you saw on the previous poster board, with little standardization across the Department, multiple systems performing the same tasks, data stored in multiple systems and substantial manual data entry.

Many of the systems in operation today date all the way back to 1950's and 1960's technology. Past reform efforts have not succeeded despite good intentions, and the intentions that led to those reform initiatives remain largely unchanged. As a result, today you have a fundamentally flawed financial management systems environment and a weak overall internal control environment.

Our testimony today has two parts: first, the root causes of the inability to effectively reform business operations; and, second, what we believe are the key elements to reform.

First, we believe the underlying causes of the chronic financial and business system problems at DOD include lack of sustained top-level leadership and accountability, cultural resistance to change and service parochialism, lack of results-oriented goals and performance measures and inadequate incentives for seeking change.

Let me briefly touch on two of these, leadership and culture. In our executive guide to world-class financial management, the leading organizations that we've studied, including General Electric, Pfizer and Boeing, all had identified leadership as the most important factor in making cultural change in establishing effective financial management.

DOD's past experience has suggested that top management has not had a proactive, consistent and continuing role in leading financial management reform. Sustaining top management commitment to performance goals is a particular challenge for DOD. In the past, the average 1.7 year tenure of the Department's top political appointees has served to hinder long-term planning and follow-through.

Cultural resistance to change and military service parochialism have also played a significant role in impeding past reform efforts. One reason for the proliferation of systems you saw earlier is the stovepiped approach that has allowed the services and DOD agencies to develop redundant solutions to business needs. For reform to succeed, all of the parts of DOD will need to put aside their pa-

rochial interests and focus on Department-wide solutions to financial management reform.

The second point we have is related to key elements necessary for reform. Our written statement discusses what we believe are seven of these elements, and I will briefly touch on two now.

First, the financial management challenges must be addressed as part of a comprehensive, integrated, DOD-wide business process. Reform effort and improvement strategy cannot be developed in a vacuum. Financial management is a cross-cutting issue that affects all of the organization's business processes.

Currently, as has been mentioned earlier, DOD has six of our 22 high-risk, agency-specific areas in the government, including system modernization and inventory management. In addition, our two governmentwide high-risk areas, human capital strategy and computer security, are also relevant to DOD. These interrelated management challenges must be addressed using an integrated, enterprise-wide approach.

Second, establishing and implementing an enterprise-wide financial management architecture will be essential for the Department to effectively manage its modernization efforts. The Clinger-Cohen Act requires agencies to develop, implement and maintain an integrated system of architecture. Such an architecture can help ensure that the Department invests only in integrated, enterprise-wide business solutions.

Building systems without an architecture is like building a house without a blueprint. And the stakes are high. As you mentioned, Mr. Chairman, for fiscal year 2003, DOD's total IT investment budget, which includes business process reform, is $26 billion. Without an architecture, DOD risks spending billions of dollars to perpetuate the existing complex, stovepiped, high-maintenance environment that exists today.

In summary, the key elements necessary for financial management reform outlined in our testimony are consistent with the findings of the DOD Financial Management Transformation Report as discussed by Mr. Friedman. As we have testified many times over the past few years, we agree with the study group's vision for financial management, which is delivering relevant, reliable and timely financial information on a routine basis to support management decisions.

Today, the momentum exists for reform and DOD has taken some actions that are consistent with a number of the key elements that I outlined earlier, but the real question remains will this momentum continue to exist tomorrow, next year and throughout the years that will be necessary to deal with these cultural systems and human capital challenges. For our part, we will continue to work constructively with DOD and the Congress on these very important matters.

Mr. Chairman, this ends my statement.

With me is Randy Hite, Dave Warren and Paul Francis; and we would all be happy to answer questions.

Mr. SHAYS. Were they all sworn in? Just the people who were sworn in.

[The prepared statement of Mr. Kutz follows:]

United States General Accounting Office

GAO

Testimony

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DOD FINANCIAL MANAGEMENT

Important Steps Underway But Reform Will Require a Long-term Commitment

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GAO-02-784T

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss financial management at the Department of Defense (DOD). Today, DOD faces financial and related management problems that are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. DOD's financial management deficiencies, taken together, represent the single largest obstacle to achieving an unqualified opinion on the U.S. government's consolidated financial statements. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of weaknesses in financial management systems, operations, and controls.

Overhauling DOD's financial management represents a major challenge that goes far beyond financial accounting to the very fiber of the department's range of business operations and management culture. Previous administrations have tried to address these problems in various ways but have been unsuccessful. In this regard, on September 10, 2001, Secretary of Defense Rumsfeld announced a broad initiative intended to "transform the way the department works and what it works on" which he estimated could save 5 percent of DOD's budget—or about $15 billion to $18 billion annually. Secretary Rumsfeld recognized that transformation would be difficult and expected the needed changes would take 8 or more years to complete. Our experience with other federal agency business transformation efforts supports the Secretary's position.

The President has made financial management and the use of technology integral to his fiscal year 2002 *Management Agenda* for making the federal government more focused on citizens and results. The President's *Management Agenda* notes, "Without accurate and timely information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people."

With the events of September 11, and the federal government's short- and long-term budget challenges, it is more important than ever that DOD effectively transform its business operations to ensure that it gets the most from every dollar spent. The department must be able to effectively carry out its stewardship responsibilities for the funding it receives and for the vast amount of equipment and inventories used in support of military operations. Even before the events of September 11, increased globalization, changing security threats, and rapid technological advances were prompting fundamental changes in the environment in which DOD operates. These trends place a premium on increasing strategic planning, enhancing results orientation, ensuring effective accountability, maintaining transparency, and using integrated approaches. Of the 22 areas on GAO's governmentwide "high-risk" list, 6 are DOD program areas, and DOD shares responsibility for 2 other high-risk areas that are government wide in scope.[1] Central to effectively addressing DOD's financial management problems will be the understanding that these eight areas are interrelated and cannot be addressed in an isolated, stovepiped, or piecemeal fashion.

The excellence of our military forces is unparalleled. This same level of excellence is not yet evident in the department's financial management and other related business areas. This is particularly problematic because effective financial and related management operations are critical to achieving the department's mission in a reasonably economical, efficient, and effective manner and to providing reliable, timely financial information on a routine basis to support management decision making at all levels throughout DOD. Transforming DOD's business operations would free up resources that could be used to enhance readiness, improve the quality of life for our troops and their families, and reduce the gap between "wants" and available funding in connection with major weapon systems.

Today, we will provide our perspectives on the (1) department's long-standing inability to effectively reform its financial management and other business systems and processes and (2) keys to successfully carrying out the Secretary's business process transformation. Last summer, the Comptroller General shared a business transformation paper with Secretary Rumsfeld and Comptroller Zakheim. This paper provided an overview of our views on the challenges facing the department, the keys to

[1]U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 2001).

effective reform, and detailed one option for addressing these challenges. Our testimony today highlights the keys to success included in that paper.

Long-standing Financial Management Problems and Attempts at Reform

History is a good teacher. To solve the problems of today, it is important to avoid repeating past mistakes. Over the past 12 years, the department has initiated several broad-based departmentwide reform efforts intended to fundamentally reform its financial operations as well as other key business areas, including the Defense Reform Initiative, the Defense Business Operations Fund, and the Corporate Information Management initiative. These efforts, which are highlighted below, have proven to be unsuccessful despite good intentions and significant effort. The conditions that led to these previous attempts at reform remain largely unchanged today.

Defense Reform Initiative (DRI). In announcing the DRI program in November 1997, the then Secretary of Defense stated that his goal was "to ignite a revolution in business affairs." DRI represented a set of proposed actions aimed at improving the effectiveness and efficiency of DOD's business operations, particularly in areas that had been long-standing problems—including financial management. In July 2000, we reported[2] that while DRI got off to a good start and made progress in implementing many of the component initiatives, it did not meet expected time frames and goals, and the extent to which savings from these initiatives would be realized was yet to be determined. We noted that a number of barriers had kept the department from meeting its specific time frames and goals. The most notable barrier was institutional resistance to change in an organization as large and complex as DOD, particularly in such areas as acquisition, financial management, and logistics, which transcend most of the department's functional organizations and have been long-standing management concerns. We also pointed out that DOD did not have a clear road map to ensure that the interrelationships between its major reform initiatives were understood and addressed and that it was investing in its highest priority requirements. We are currently examining the extent to which DRI efforts begun under the previous administration are continuing.

Defense Business Operations Fund. In October 1991, DOD established a new entity, the Defense Business Operations Fund by consolidating nine

[2]U.S. General Accounting Office, *Defense Management: Actions Needed to Sustain Reform Initiatives and Achieve Greater Results*, GAO/NSIAD-00-72 (Washington, D.C.: July 25, 2000).

existing industrial and stock funds and five other activities operated throughout DOD. Through this consolidation, the fund was intended to bring greater visibility and management to the overall cost of carrying out certain critical DOD business operations. However, from its inception, we reported that the fund did not have the policies, procedures, and financial systems to operate in a businesslike manner. In 1996, DOD announced the fund's elimination. In its place, DOD established four working capital funds. DOD estimated that for fiscal year 2003 these funds would account for and control about $75 billion. These new working capital funds inherited their predecessor's operational and financial reporting problems. Our reviews of these funds have found that they still are not in a position to provide accurate and timely information on the results of operations. As a result, working capital fund customers cannot be assured that the prices they are charged for goods and services represent actual costs.

Corporate Information Management (CIM). The CIM initiative began in 1989 and was expected to save billions of dollars by streamlining operations and implementing standard information systems to support common business operations. CIM was expected to reform all of DOD's functional areas—including finance, procurement, material management, and human resources—through consolidating, standardizing, and integrating information systems. DOD also expected CIM to replace approximately 2,000 duplicative systems. Over the years, we made numerous recommendations to improve CIM's management to help preclude the wasteful use and mismanagement of billion of dollars. However, these recommendations were generally not addressed. Instead, DOD spent billions of dollars with little sound analytical justification. Rather than relying on a rigorous decision-making process for information technology investments—as used in leading private and public organizations we studied, DOD made systems decisions without (1) appropriately analyzing cost, benefits, and technical risks; (2) establishing realistic project schedules; or (3) considering how business process improvements could affect information technology investments. For one effort alone, DOD spent about $700 million trying to develop and implement a single system for the material management business area—but this effort proved unsuccessful. We reported in 1997[3] that the benefits of CIM had yet to be widely achieved after 8 years of effort and spending about $20 billion. The CIM initiative was eventually abandoned.

[3]U.S. General Accounting Office, *High-Risk Series: Information Management and Technology*, GAO/HR-97-9 (Washington, D.C.: Feb. 1997).

DOD's long-standing financial management difficulties have adversely affected the department's ability to control costs, ensure basic accountability, anticipate future costs and claims on the budget (such as for health care, weapon systems, and environmental liabilities), measure performance, maintain funds control, prevent fraud, and address pressing management issues.

In this regard, I would like to briefly highlight three of our recent products that exemplify the adverse impact of DOD's reliance on fundamentally flawed financial management systems and processes and a weak overall internal control environment.

- In March of this year, we testified[4] on the continuing problems with internal controls over approximately $64 million in fiscal year 2001 purchase card transactions involving two Navy activities. Consistent with our testimony[5] last July on fiscal year 2000 purchase card transactions at these locations, our follow-up review demonstrated that continuing control problems contributed to fraudulent, improper, and abusive purchases and theft and misuse of government property. We are currently auditing purchase and travel card usage across the department.

- In July 2001, we reported[6] that DOD did not have adequate systems, controls, and managerial attention to ensure that the $2.7 billion of adjustments affecting closed appropriation accounts made during fiscal year 2000 were legal and otherwise proper. Our review of $2.2 billion of these adjustments found about $615 million (28 percent) of the adjustments should not have been made, including about $146 million that violated specific provisions of appropriations law and were thus illegal. For example, the stated purpose of one adjustment was to charge a $79 million payment made in February 1999 to a fiscal year 1992 research and development appropriation account to correct previous payment recording errors. However, the fiscal year 1992 research and

[4]U.S. General Accounting Office, *Purchase Cards: Continued Control Weaknesses Leave Two Navy Units Vulnerable to Fraud and Abuse*, GAO-02-504T (Washington, D.C.: Mar. 13, 2002).

[5]U.S. General Accounting Office, *Purchase Cards: Control Weaknesses Leave Two Navy Units Vulnerable to Fraud and Abuse*, GAO-01-995T (Washington, D.C.: July 30, 2001).

[6]U.S. General Accounting Office, *Canceled DOD Appropriations: $615 Million of Illegal or Otherwise Improper Adjustments*, GAO-01-994T (Washington, D.C.: July 26, 2001).

development appropriation account closed at the end of fiscal year 1998—4 months before the $79 million payment was made. Therefore, the adjustment had the same effect as using canceled funds from a closed appropriation account to make the February 1999 expenditure, which is prohibited by the 1990 law. As of April 2002, DOD had reversed 140 of the 162 transactions and provided additional contract documentation for the remaining 22 transactions. However, DOD has yet to complete the reconciliation for the contracts associated with these adjustments and make the correcting entries. DOD has indicated that it will be later this year before the correct entries are made.

- In June 2001, we reported[7] that DOD's financial systems could not adequately track and report on whether the $1.1 billion in earmarked funds that the Congress provided to DOD for spare parts and associated logistical support were actually used for their intended purpose. The vast majority of the funds—92 percent—were transferred to the military services operation and maintenance accounts. Once the funds were transferred into the operation and maintenance accounts, the department could not separately track the use of the funds. As a result, DOD lost its ability to assure the Congress that the funds it received for spare parts purchases were used for, and only for, that purpose.

Problems with the department's financial management operations go far beyond its accounting and finance systems and processes. The department continues to rely on a far-flung, complex network of finance, logistics, personnel, acquisition, and other management information systems—80 percent of which are not under the control of the DOD Comptroller—to gather the financial data needed to support the day-to-day management decision making. This network was not designed to be, but rather has evolved into, the overly complex and error-prone operation that exists today, including (1) little standardization across DOD components, (2) multiple systems performing the same tasks, (3) the same data stored in multiple systems, (4) manual data entry into multiple systems, and (5) a large number of data translations and interfaces that combine to exacerbate problems with data integrity.

Many of the department's business operations are mired in old, inefficient processes and legacy systems, some of which go back to the 1950s and

[7]U.S. General Accounting Office, *Defense Inventory: Information on the Use of Spare Parts Funding Is Lacking*, GAO-01-472 (Washington, D.C.: June 11, 2001).

1960s. For example, the department still relies on the Mechanization of Contract Administration Services (MOCAS) system—which dates back to 1968—to process a substantial portion of the contract payment transactions for all DOD organizations. In fiscal year 2001, MOCAS processed an estimated $78 billion in contract payments. Past efforts to replace MOCAS have failed and the current effort has been delayed. As a result, for the foreseeable future, DOD will continue to be saddled with MOCAS.

In the 1970s, we issued numerous reports detailing serious problems with the department's financial management operations. Between 1975 and 1981, we issued more than 75 reports documenting serious problems with DOD's cost, property, fund control, and payroll accounting systems. In the 1980s, we found that despite the billions of dollars invested in individual systems, these efforts, too, fell far short of the mark, with extensive schedule delays and cost overruns. For example, our 1989 report[5] on eight major DOD system development efforts—including two major accounting systems—under way at that time, showed that system development cost estimates doubled, two of the eight efforts were abandoned, and the remaining six efforts experienced delays of 3 to 7 years.

Two recent specific system endeavors that have fallen short of their intended goals are the Standard Procurement System and the Defense Joint Accounting System. Both of these efforts were aimed at improving the department's financial management and related business operations.

[5]U.S. General Accounting Office, *Automated Information Systems: Schedule Delays and Cost Overruns Plague DOD Systems*, GAO/IMTEC-89-36 (Washington, D.C.: May 10, 1989).

Standard Procurement System (SPS). In November 1994, DOD began the SPS program to acquire and deploy a single automated system to perform all contract management-related functions within DOD's procurement process for all DOD organizations and activities. The laudable goal of SPS was to replace 76 existing procurement systems with a single departmental system. DOD estimated that SPS had a life-cycle cost of approximately $3 billion over a 10-year period. According to DOD, SPS was to support about 43,000 users at over 1,000 sites worldwide and was to interface with key financial management functions such as payment processing. Additionally, SPS was intended to replace the contract administration functions currently performed by MOCAS. Our July 2001 report[9] and February 2002 testimony[10] before this Subcommittee identified weaknesses in the department's management of its investment in SPS. Specifically:

- The department had not economically justified its investment in the program because its latest (January 2000) analysis of costs and benefits was not credible. Further, this analysis showed that the system, as defined, was not a cost-beneficial investment.
- The department was not accumulating actual program costs and therefore, did not know the total amount spent on the program to date, yet life-cycle cost projections had grown from about $3 billion to $3.7 billion.
- Although the department committed to fully implementing the system by March 31, 2000, this target date had slipped by over 3 ½ years to September 30, 2003, and program officials have recently stated that this date will also not be met.

We recommended that the Secretary of Defense make additional investments in SPS conditional upon first demonstrating that the existing version of SPS is producing benefits that exceed costs and that future investment decisions, including those regarding operations and

[9]U.S. General Accounting Office, *DOD Systems Modernization: Continued Investment in the Standard Procurement System Has Not Been Justified*, GAO-01-682 (Washington, D.C.: July 31, 2001).

[10]U.S. General Accounting Office, *DOD's Standard Procurement System: Continued Investment Has Yet to Be Justified*, GAO-02-392T (Washington, D.C.: Feb. 7, 2002).

maintenance beyond fiscal year 2001, be based on complete and reliable economic justifications.

Defense Joint Accounting System (DJAS). In 1997, DOD selected DJAS[11] to be one of three general fund accounting systems.[12] As originally envisioned, DJAS would perform the accounting for the Army and the Air Force as well as the DOD transportation and security assistance areas. Subsequently, in February 1998, the Defense Finance and Accounting Service (DFAS) decided that the Air Force could withdraw from using DJAS. DFAS made the decision because either the Air Force processes or the DJAS processes would need significant reengineering to allow for the development of a joint accounting system. As a result, the Air Force was allowed to start development of its own general fund accounting system—General Fund and Finance System—which resulted in the development of a fourth general fund accounting system.

In June 2000, the DOD Inspector General reported[13] that DFAS was developing DJAS at an estimated life-cycle cost of about $700 million without demonstrating that the program was the most cost-effective alternative for providing a portion of DOD's general fund accounting. More specifically, the report stated that DFAS had not developed a complete or fully supportable feasibility study, analysis of alternatives, economic analysis, acquisition program baseline, or performance measures, and had not reengineered business processes. According to data provided by DFAS, for fiscal years 1997-2000 approximately $120 million was spent on the development and implementation of DJAS. However, today DJAS is only being operated at two locations—Ft. Benning, Georgia, and the Missile Defense Agency. According to a DFAS official, DJAS is considered to be fully deployed—which means it is operating at all intended locations.

Significant resources—in terms of dollars, time, and people—have been invested in these two efforts, without demonstrated improvement in DOD's

[11]The original name of the system was the Corps of Engineers Financial Management System (CEFMS). After it was determined that CEFMS could be modified to satisfy Army customers and had the potential for supporting the Defense Working Capital Funds, DFAS selected CEFMS to meet the DJAS requirements.

[12]The other two general fund systems were the Standard Accounting and Reporting System and the Standard Accounting and Budgetary Reporting System.

[13]Department of Defense Office of the Inspector General, *Acquisition of the Defense Joint Accounting System*, Report No. D-2000-151 (Arlington, VA.: June 16, 2000).

business operations. It is essential that DOD ensure that its investment in systems modernization results in more effective and efficient business operations, since every dollar spent on ill-fated efforts such as SPS and DJAS is one less dollar available for other defense spending priorities.

Underlying Causes of Financial and Related Business Process Reform Challenges

As part of our constructive engagement approach with DOD, the Comptroller General met with Secretary Rumsfeld last summer to provide our perspectives on the underlying causes of the problems that have impeded past reform efforts at the department and to discuss options for addressing these challenges. There are four underlying causes:

- a lack of sustained top-level leadership and management accountability for correcting problems;
- deeply embedded cultural resistance to change, including military service parochialism and stovepiped operations;
- a lack of results-oriented goals and performance measures and monitoring; and
- inadequate incentives for seeking change.

Lack of Sustained Leadership and Accountability

Historically, DOD has not routinely assigned accountability for performance to specific organizations or individuals who have sufficient authority to accomplish desired goals. For example, under the CFO Act, it is the responsibility of agency CFOs to establish the mission and vision for the agency's future financial management. However, at DOD, the Comptroller—who is by statute the department's CFO—has direct responsibility for only an estimated 20 percent of the data relied on to carry out the department's financial management operations.

- The department has learned through its efforts to meet the Year 2000 computing challenge that to be successful, major improvement initiatives must have the direct, active support and involvement of the Secretary and Deputy Secretary of Defense. In the Year 2000 case, the then Deputy Secretary of Defense was personally and substantially involved and played a major role in the department's success. Such top-level support and attention helps ensure that daily activities throughout the department remain focused on achieving shared, agencywide outcomes. A central finding from our report on our survey of best practices of world-class financial management organizations—Boeing; Chase Manhattan Bank; General Electric; Pfizer; Hewlett-Packard; Owens Corning; and the states of Massachusetts, Texas, and Virginia—was that clear, strong executive leadership was essential to (1) making financial management an entitywide priority, (2) redefining the role of finance, (3) providing meaningful information to decision makers, and (4) building a team of people that delivers results.[14]

DOD's past experience has suggested that top management has not had a proactive, consistent, and continuing role in building capacity, integrating daily operations for achieving performance goals, and creating incentives. Sustaining top management commitment to performance goals is a particular challenge for DOD. In the past, the average 1.7-year tenure of the department's top political appointees has served to hinder long-term planning and follow-through.

Cultural Resistance and Parochialism

Cultural resistance to change and military service parochialism have also played a significant role in impeding previous attempts to implement broad-based management reforms at DOD. The department has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization, and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures.

[14]U.S. General Accounting Office, *Executive Guide: Creating Value Through World-class Financial Management*, GAO/AIMD-00-134 (Washington, D.C.: Apr. 2000).

For example, as discussed in our July 2000 report,[15] the department encountered resistance to developing departmentwide solutions under the then Secretary's broad-based DRI. In 1997, the department established a Defense Management Council—including high-level representatives from each of the military services and other senior executives in the Office of the Secretary of Defense—which was intended to serve as the "board of directors" to help break down organizational stovepipes and overcome cultural resistance to change called for under DRI. However, we found that the council's effectiveness was impaired because members were not able to put their individual military services' or DOD agencies' interests aside to focus on departmentwide approaches to long-standing problems.

Cultural resistance to change has impeded reforms not only in financial management, but also in other business areas, such as weapon system acquisition and inventory management. For example, as we reported[16] last year, while the individual military services conduct considerable analyses justifying major acquisitions, these analyses can be narrowly focused and do not consider joint acquisitions with the other services. In the inventory management area, DOD's culture has supported buying and storing multiple layers of inventory rather than managing with just the amount of stock needed.

Unclear Goals and Performance Measures

DOD's past reform efforts have been handicapped by the lack of clear, linked goals and performance measures. As a result, DOD managers lack straightforward road maps showing how their work contributes to attaining the department's strategic goals, and they risk operating autonomously rather than collectively. In some cases, DOD had not yet developed appropriate strategic goals, and in other cases, its strategic goals and objectives were not linked to those of the military services and defense agencies.

As part of our assessment of *DOD's Fiscal Year 2000 Financial Management Improvement Plan*, we reported[17] that, for the most part, the

[15]GAO/NSIAD-00-72.

[16]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Defense*, GAO-01-244 (Washington D.C.: Jan. 2001).

[17]U.S. General Accounting Office, *Financial Management: DOD Improvement Plan Needs Strategic Focus*, GAO-01-764 (Washington D.C.: Aug. 17, 2001).

plan represented the military services' and defense components' stovepiped approaches to reforming financial management and did not clearly articulate how these various efforts would collectively result in an integrated DOD-wide approach to financial management improvement. In addition, we reported that the department's plan did not include performance measures that could be used to assess DOD's progress in resolving its financial management problems. DOD officials have informed us that they are now working to revise the department's approach to this plan so that future years' updates will reflect a more strategic, departmentwide vision and provide a more effective tool for financial management reform.

As it moves to modernize its systems, the department faces a formidable challenge in responding to technological advances that are changing traditional approaches to business management. For fiscal year 2003, DOD's information technology budgetary request of approximately $26 billion will support a wide range of military operations as well as DOD business functions. As we have reported,[18] while DOD plans to invest billions of dollars in modernizing its financial management and other business support systems, it does not yet have an overall blueprint—or enterprise architecture—in place to guide and direct these investments. As we recently testified,[19] our review of practices at leading organizations showed they were able to make sure their business systems addressed corporate—rather than individual business unit—objectives by using enterprise architectures to guide and constrain investments. Consistent with our recommendation, DOD is now working to develop a financial management enterprise architecture, which is a very positive development.

Lack of Incentives for Change

The final underlying cause of the department's long-standing inability to carry out needed fundamental reform has been the lack of incentives for making more than incremental change to existing "business-as-usual" processes, systems, and structures. Traditionally, DOD has focused on justifying its need for more funding rather than on the outcomes its programs have produced. DOD generally measures its performance by the

[18]U.S. General Accounting Office, *Information Technology: Architecture Needed to Guide Modernization of DOD's Financial Operations*, GAO-01-525 (Washington, D.C.: May 17, 2001).

[19]U.S. General Accounting Office, *Defense Acquisitions: DOD Faces Challenges in Implementing Best Practices*, GAO-02-469T (Washington, D.C.: Feb. 27, 2002).

amount of money spent, people employed, or number of tasks completed. Incentives for its decision makers to implement changed behavior have been minimal or nonexistent. Secretary Rumsfeld perhaps said it best in announcing his planned transformation at DOD: "There will be real consequences from, and real resistance to, fundamental change."

This lack of incentive has perhaps been most evident in the department's acquisition area. In DOD's culture, the success of a manager's career has depended more on moving programs and operations through the DOD process than on achieving better program outcomes. The fact that a given program may have cost more than estimated, taken longer to complete, and not generated results or performed as promised was secondary to fielding a new program. To effect real change, actions are needed to (1) break down parochialism and reward behaviors that meet DOD-wide and congressional goals; (2) develop incentives that motivate decision makers to initiate and implement efforts that are consistent with better program outcomes, including saying "no" or pulling the plug on a system or program that is failing; and (3) facilitate a congressional focus on results-oriented management, particularly with respect to resource-allocation decisions.

Independent Assessment Calls for the Reform of DOD's Financial Operations

Recognizing the need for improved financial data to effectively manage the department's vast operations, Secretary Rumsfeld commissioned an independent study to recommend a strategy for financial management improvements. The report[20] recognized that the department would have to undergo "a radical financial management transformation" and that it would take more than a decade to achieve. The report also noted that DOD's current financial, accounting, and feeder systems do not provide relevant, reliable, and timely information. Further, the report pointed out that the "support of management decision-making" is generally not an objective of the financially based information currently developed or planned for future development. Additionally, the report stated that although the department had numerous system projects underway, they were narrowly focused, lacked senior management leadership, and were not part of an integrated DOD-wide strategy. The report also noted that the systemic problems discussed were not strictly financial management problems and could not be solved by DOD's financial community. Rather, the solution would

[20]Department of Defense, *Transforming Department of Defense Financial Management: A Strategy for Change* (Washington, D.C.: Apr. 13, 2001).

require the "concerted effort and cooperation of cross-functional communities throughout the department."

The report recommended an integrated approach to transform the department's financial operations. The report noted that its proposed framework would take advantage of certain ongoing improvement actions within the department and provide specific direction for a more coordinated, managed, and results-oriented approach. The proposed course of action for transforming the department's financial management centered around six broad elements: (1) leadership, (2) incentives, (3) accountability, (4) organizational alignment, (5) changes in certain rules, and (6) changes in enterprise practices.

The report referred to its approach as a "twin-track" course of action. The first track employs a DOD-wide management approach to developing standard integrated systems; obtaining relevant, reliable, and timely financial data; and providing incentives for the department to utilize financial data in an efficient and effective way. This track will require a longer time frame and will include establishing a centralized oversight process under the DOD Comptroller for incrementally implementing the recommended structural changes and developing standard, integrated financial systems.

The second track focuses on targeting, selecting, and overseeing implementation of a limited number of intraservice/cross-service projects for major cost savings or other high-value benefits under a process led by the DOD Comptroller and assisting the Secretary of Defense in establishing and managing a set of metrics. Prime tools of such improvements would include activity-based costing and benchmarking/best practices analysis to identify cost-saving opportunities.

A July 19, 2001, departmental memorandum from Secretary Rumsfeld confirmed that the department needs to develop and implement an architecture for achieving integrated financial and accounting systems in order to generate relevant, reliable, and timely information on a routine basis. Secretary Rumsfeld further reiterated the need for a fundamental transformation of DOD in his "top-down" Quadrennial Defense Review. Specifically, his September 30, 2001, *Quadrennial Defense Review Report* concluded that the department must transform its outdated support structure, including decades-old financial systems that are not well interconnected. The report summed up the challenge well in stating: "While America's businesses have streamlined and adopted new business

models to react to fast-moving changes in markets and technologies, the Defense Department has lagged behind without an overarching strategy to improve its business practices."

Keys to Fundamental DOD Financial Management Reform

Our experience has shown there are several key elements that collectively would enable the department to effectively address the underlying causes of its inability to resolve its long-standing financial management problems. For the most part these elements are consistent with those discussed in the department's April 2001 financial management transformation report. These elements, which we believe are key to any successful approach to financial management reform, include

- addressing the department's financial management challenges as part of a comprehensive, integrated, DOD-wide business reform;
- providing for sustained leadership by the Secretary of Defense and resource control to implement needed financial management reforms;
- establishing clear lines of responsibility, authority, and accountability for such reform tied to the Secretary;
- incorporating results-oriented performance measures and monitoring tied to financial management reforms;
- providing appropriate incentives or consequences for action or inaction;
- establishing and implementing an enterprise architecture to guide and direct financial management modernization investments; and
- ensuring effective oversight and monitoring.

Actions on many of the key areas central to successfully achieving desired financial management and related business transformation goals—particularly those that rely on longer term systems improvements—will take a number of years to fully implement. Secretary Rumsfeld has estimated that his envisioned transformation may take 8 or more years to complete. Our research and experience with other federal agencies have shown that this is not an unrealistic estimate. Additionally, these keys should not be viewed as independent actions, but rather, a set of interrelated and interdependent actions that are collectively critical to transforming DOD's business operations.

Consequently, both long-term actions focused on the Secretary's envisioned business transformation and short-term actions focused on improvements within existing systems and processes will be critical going forward. Short-term actions in particular will be critical if the department is to achieve the greatest possible accountability over existing resources and more reliable data for day-to-day decision making while longer term systems and business process reengineering efforts are under way. Beginning with the Secretary's recognition of a need for a fundamental transformation of the department's business operations and building on some of the work begun under past administrations, DOD has taken a number of positive steps in many of these key areas, but these steps are only a beginning. Challenges remain in each of these key areas that are formidable.

Integrated Business Reform Strategy

As we previously reported,[21] establishing the right goal is essential for success. Central to effectively addressing DOD's financial management problems will be the recognition that they cannot be addressed in an isolated, stovepiped, or piecemeal fashion separate from the other high-risk areas facing the department.[22] Further, successfully reforming the department's operations—which consist of people, business processes, and technology—will be critical if DOD is to effectively address the deep-rooted organizational emphasis on maintaining business-as-usual across the department.

[21]U.S. General Accounting Office, *Department of Defense: Progress in Financial Management Reform*, GAO/T-AIMD/NSIAD-00-163 (Washington, D.C.: May 9, 2000).

[22]The eight interrelated high-risk areas that represent the greatest challenge to DOD's developing world-class business operations supporting its forces are: contract management, financial management, human capital, information security, infrastructure management, inventory management, systems modernization, and weapon system acquisition.

Financial management is a crosscutting issue that affects virtually all of DOD's business areas. For example, improving its financial management operations so that they can produce timely, reliable, and useful cost information is essential to effectively measure its progress toward achieving many key outcomes and goals across virtually the entire spectrum of DOD's business operations. At the same time, the department's financial management problems—and, most importantly, the keys to their resolution—are deeply rooted in and dependent upon developing solutions to a wide variety of management problems across DOD's various organizations and business areas. For example, we have reported[23] that many of DOD's financial management shortcomings were attributable in part to human capital issues. The department does not yet have a strategy in place for improving its financial management human capital. This is especially critical in connection with DOD's civilian workforce, since DOD has generally done a much better job in conjunction with human capital planning for its military personnel. In addition, DOD's civilian personnel face a variety of size, shape, skills, and succession-planning challenges that need to be addressed.

As we mentioned earlier, and it bears repetition, the department has reported that an estimated 80 percent of the data needed for sound financial management comes from its other business operations, such as its acquisition and logistics communities. DOD's vast array of costly, nonintegrated, duplicative, and inefficient financial management systems is reflective of its lack of an integrated approach to addressing management challenges. DOD has acknowledged that one of the reasons for the lack of clarity in its reporting under the Government Performance and Results Act has been that most of the program outcomes the department is striving to achieve are interrelated, while its management systems are not integrated.

As we discussed previously, the Secretary of Defense has made the fundamental transformation of business practices throughout the department a top priority. In this context, the Secretary established a number of top-level committees, councils, and boards, including the Senior Executive Committee, Business Initiative Council, and Defense Business Practices Implementation Board. The Senior Executive Committee was established to help guide efforts across the department to improve its business practices. This committee—chaired by the Secretary of Defense,

[23]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Defense*, GAO-01-244 (Washington, D.C.: Jan. 2001).

and with membership to include the Deputy Secretary, the military service secretaries, and the Under Secretary of Defense for Acquisition, Technology and Logistics—was established to function as the "board of directors" for the department. The Business Initiative Council—comprising the military service secretaries and headed by the Under Secretary of Defense for Acquisition, Technology and Logistics—was established to encourage the military services to explore new money-saving business practices to help offset funding requirements for transformation and other initiatives.

Our research of successful public and private sector organizations shows that such entities, comprised of enterprisewide executive leadership, provide valuable guidance and direction when pursuing integrated solutions to corporate problems. Inclusion of the department's top leadership should help to break down the cultural barriers to change and result in an integrated DOD approach for business reform.

Sustained Leadership and Resource Control

The department's successful Year 2000 effort illustrated, and our survey of leading financial management organizations[24] captured, the importance of strong leadership from top management. As we have stated many times before, strong, sustained executive leadership is critical to changing a deeply rooted corporate culture—such as the existing "business-as-usual" culture at DOD—and to successfully implementing financial management reform. In the case of the Year 2000 challenge the personal, active involvement of the Deputy Secretary of Defense played a key role in building entitywide support and focus. Given the long-standing and deeply entrenched nature of the department's financial management problems—combined with the numerous competing DOD organizations, each operating with varying, often parochial views and incentives—such visible, sustained top-level leadership will be critical.

In discussing their April 2001 report to the Secretary of Defense on transforming financial management,[25] the authors stated that, "unlike previous failed attempts to improve DOD's financial practices, there is a

[24]U.S. General Accounting Office, *Executive Guide: Creating Value Through World-class Financial Management*, GAO/AIMD-00-134 (Washington, D.C.: Apr. 2000).

[25]Department of Defense, *Transforming Department of Defense Financial Management: A Strategy for Change* (Washington, D.C.: Apr. 13, 2001).

new push by DOD leadership to make this issue a priority." Strong, sustained executive leadership—over a number of years and administrations—will be key to changing a deeply rooted culture. In addition, given that significant investments in information systems and related processes have historically occurred in a largely decentralized manner throughout the department, additional actions will likely be required to implement centralized information technology investment control.

In our May 2001 report[26] we recommended that DOD take action to provide senior departmental commitment and leadership through establishment of a enterprisewide steering committee sponsored by the Secretary, that could guide development of a transformation blueprint and provide for centralized control over investments to ensure funding is provided for only those proposed investments in systems and business reforms that are consistent with the blueprint. Absent such a control, DOD runs the serious risk that the fiscal year 2003 information technology budgetary request of approximately $26 billion and future years' requests will not result in marked improvement in DOD's business operations. Without such an approach, DOD runs the risk of spending billions of dollars on systems modernization, which continues to perpetuate the existing systems environment that suffers from duplication of systems, limited interoperability, and unnecessarily costly operations and maintenance and will preclude DOD from achieving the Secretary's vision of improved financial information on the results of departmental operations.

Additionally, as previously discussed, the tenure of the department's top political appointees has generally been short in duration and as a result it is sometimes difficult to maintain the focus and momentum that is needed to resolve the management challenges facing DOD. The resolution of the array of interrelated business system management challenges previously discussed is likely to require a number of years and therefore span several administrations. The Comptroller General has proposed in congressional testimony that one option to consider to address the continuity issue would be the establishment of the position of chief operating officer. This position could be filled by an individual appointed for a set term of 5 to 7 years with the potential for reappointment. Such an individual should have a proven track record as a business process change agent for large, diverse

[26]U.S. General Accounting Office, *Information Technology: Architecture Needed to Guide Modernization of DOD's Financial Operations*, GAO-01-525 (Washington, D.C.: May 2001).

organizations and would spearhead business process transformation across the department.

Clear Lines of Responsibility and Accountability

Last summer, when the Comptroller General met with Secretary Rumsfeld, he stressed the importance of establishing clear lines of responsibility, decision-making authority, and resource control for actions across the department tied to the Secretary as a key to reform. As we previously reported,[27] such an accountability structure should emanate from the highest levels and include the secretary of each of the military services as well as heads of the department's various major business areas.

The Secretary of Defense has taken action to vest responsibility and accountability for financial management modernization with the DOD Comptroller. In October 2001, the DOD Comptroller, as previously mentioned, established the Financial Management Modernization Executive[28] and Steering Committees as the governing bodies that oversee the activities related to this modernization effort and also established a supporting working group to provide day-to-day guidance and direction in these efforts. DOD reports that the executive and steering committees met for the first time in January 2002. At the request of the Subcommittee on Readiness and Management Support, Senate Committee on Armed Services, we are initiating a review of the department's efforts to develop and implement an enterprise architecture. As part of the effort, we will be assessing the department's efforts to align current investments in financial systems with the proposed architecture.

It is clear to us that the DOD Comptroller has the full support of the Secretary and that the Secretary is committed to making meaningful change. The key is to translate this support into a funding control mechanism that ensures DOD's components information technology investments are aligned with the department's strategic blueprint. Addressing issues such as centralization of authority for information systems investments and continuity of leadership is critical to successful business transformation. To make this work, it is important that the DOD Comptroller have sufficient authority to oversee the investment decisions

[27]GAO/NSIAD-00-72.

[28]The structure and responsibilities of the Executive Committee as outlined in the October 2001 memorandum are consistent with the provisions of Section 1009 of Public Law 107-107.

in order to bring about the full, effective participation of the military services and business process owners across the department.

Results-oriented Performance

As discussed in our January 2001 report on DOD's major performance and accountability challenges,[29] establishing a results orientation is another key element of any approach to reform. Such an orientation should draw upon results that could be achieved through commercial best practices, including outsourcing and shared servicing concepts. Personnel throughout the department must share the common goal of establishing financial management operations that not only produce financial statements that can withstand the test of an audit but more importantly, routinely generate useful, reliable, and timely financial information for day-to-day management purposes.

In addition, we have previously testified[30] that DOD's financial management improvement efforts should be measured against an overall goal of effectively supporting DOD's basic business processes, including appropriately considering related business process system interrelationships, rather than determining system-by-system compliance. Such a results-oriented focus is also consistent with an important lesson learned from the department's Year 2000 experience. DOD's initial Year 2000 focus was geared toward ensuring compliance on a system-by-system basis and did not appropriately consider the interrelationships of systems and business areas across the department. It was not until the department, under the direction of the then Deputy Secretary, shifted to a core mission and function review approach that it was able to achieve the desired result of greatly reducing its Year 2000 risk.

Since the Secretary has established an overall business process transformation goal that will require a number of years to achieve, going forward it is especially critical for managers throughout the department to focus on specific metrics that, over time, collectively will translate to achieving this overall goal. It is important for the department to refocus its annual accountability reporting on this overall goal of fundamentally transforming the department's financial management systems and related

[29]GAO-01-244.

[30]GAO/T-AIMD/NSIAD-00-163.

business processes to include appropriate interim annual measures for tracking progress toward this goal.

In the short term, it is important to focus on actions that can be taken using existing systems and processes. It is critical to establish interim measures to both track performance against the department's overall transformation goals and facilitate near-term successes using existing systems and processes. The department has established an initial set of metrics intended to evaluate financial performance, and it reports that it has seen improvements. For example, with respect to closed appropriation accounts, DOD reported during the first 6 months of fiscal year 2002 a reduction in the dollar value of adjustments to closed appropriation accounts of about 80 percent from the same 6-month period in fiscal year 2001. Other existing metrics concern cash and funds management, contract and vendor payments, and disbursement accounting. We are initiating a review of DOD's short-term financial management performance metrics and will provide the Subcommittee the results of our review. DOD also reported that it is working to develop these metrics into higher-level measures more appropriate for senior management. We agree with the department's efforts to expand the use of appropriate metrics to guide its financial management reform efforts.

Incentives and Consequences

Another key to breaking down the parochial interests and stovepiped approaches that have plagued previous reform efforts is establishing mechanisms to reward organizations and individuals for behaviors that comply with DOD-wide and congressional goals. Such mechanisms should be geared to providing appropriate incentives and penalties to motivate decision makers to initiate and implement efforts that result in fundamentally reformed financial management and other business support operations.

In addition, such incentives and consequences are essential if DOD is to break down the parochial interests that have plagued previous reform efforts. Incentives driving traditional ways of doing business, for example, must be changed, and cultural resistance to new approaches must be overcome. Simply put, DOD must convince people throughout the department that they must change from business-as-usual systems and practices or they are likely to face serious consequences, organizationally and personally.

Enterprise Architecture

Enterprise architecture development, implementation, and maintenance are a basic tenet of effective information technology management. Used in concert with other information technology management controls, an architecture can increase the chances for optimal mission performance. We have found that attempting to modernize operations and systems without an architecture leads to operational and systems duplication, lack of integration, and unnecessary expense. Our best practices research of successful public and private sector organizations has similarly identified enterprise architectures as essential to effective business and technology transformation.[31]

Establishing and implementing a financial management enterprise architecture is essential for the department to effectively manage its modernization effort. The Clinger-Cohen Act requires major departments and agencies to develop, implement, and maintain an integrated architecture. As we previously reported,[32] such an architecture can help ensure that the department invests only in integrated, business system solutions and, conversely, will help move resources away from non-value-added legacy business systems and nonintegrated business system development efforts. Without an enterprise architecture to guide and constrain information technology investments, DOD runs the serious risk that its system efforts will perpetuate the existing system environment that suffers from systems duplication, limited interoperability, and unnecessarily costly operations and maintenance.

In our May 2001 report,[33] we pointed out that DOD lacks a financial management enterprise architecture to guide and constrain the billions of dollars it plans to spend to modernize its financial management operations and systems. According, we recommended that the department develop and implement an architecture in accordance with DOD's policies and guidance and that senior management be involved in the investment decision-making process.

[31]U.S. General Accounting Office, *Executive Guide: Improving Mission Performance through Strategic Information Management and Technology*, GAO/AIMD-94-115 (Washington, D.C.: May 1994).

[32]GAO/T-AIMD/NSIAD-00-163.

[33]GAO-01-525.

DOD has awarded a contract for the development of a DOD-wide financial management enterprise architecture to "achieve the Secretary's vision of relevant, reliable and timely financial information needed to support informed decision-making." In fiscal year 2002, DOD received approximately $98 million and has requested another $96 million for fiscal year 2003 for this effort. Consistent with the recommendations contained in our January 1999[34] and May 2001 reports, DOD has begun an extensive effort to document the department's current "as-is" financial management architecture by identifying systems currently relied upon to carry out financial management operations throughout the department. To date, the department has identified over 1,100 systems that are involved in the processing of financial information. In developing the "as-is" environment DOD has recognized that financial management is broader than just accounting and finance systems. Rather, it includes the department's budget formulation, acquisition, inventory management, logistics, personnel, and property management systems.

In developing and implementing its enterprise architecture, DOD needs to ensure that the multitude of systems efforts currently underway are designed as an integral part of the architecture. As discussed in our May 2001 report,[35] the Army and the Defense Logistics Agency (DLA) are investing in financial management solutions that are estimated to cost about $700 million and $900 million, respectively. Further, the Naval Audit Service has reported that the Navy has efforts underway which are estimated to cost about $2.5 billion.[36] These programs—commercial enterprise resource planning (ERP) products—are intended to implement different commercially available products for automating and reengineering various operations within the organization.[37] Among the functions that these ERP programs address is financial management. However, since DOD has yet to develop and implement its architecture,

[34]U.S. General Accounting Office, *Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan*, GAO/AIMD-99-44 (Washington, D.C.: Jan.29, 1999).

[35]GAO-01-525.

[36]Naval Audit Service, *Department of the Navy Implementation of Enterprise Resource Planning Solutions*, N2002-0024 (Washington, D.C.: Jan. 25, 2002).

[37]ERP products consist of multiple, integrated functional modules that do different tasks, such as track payroll, keep a standard general ledger, manage supply chains, and organize customer data.

there is no assurance that these separate efforts will result in systems that are compatible with the DOD designated architecture. For example, the Naval Audit Service reported that there are interoperability problems with the four Navy ERP efforts and the entire program lacks appropriate management oversight.

The effort to develop a financial management architecture will be further complicated as the department strives to develop multiple architectures across its various business areas and organizational components. For example, in June 2001, we recommended[38] that the DLA develop an architecture to guide and constrain its Business Systems Modernization acquisition. Additionally, we recommended that the department develop a DOD-wide logistics management architecture that would promote interoperability and avoid duplication among the logistics modernization efforts now under way in DOD component organizations, such as DLA and the military services.

As previously discussed, control and accountability over investments are critical. DOD can ill-afford another CIM, which invested billion of dollars but did not result in systems that were capable of providing DOD management and the Congress with more accurate, timely, and reliable information of the results of the department's vast operations. To better control DOD's investments we recommended in our May 2001 report,[39] that until the architecture is developed investments should be limited to (1) deployment of systems that have already been fully tested and involve no additional development or acquisition cost, (2) stay-in-business maintenance needed to keep existing systems operational, (3) management controls needed to effectively invest in modernized systems, and (4) new systems or existing system changes that are congressionally directed or are relatively small, cost effective, and low risk and can be delivered in a relatively short time frame.

[38]U.S. General Accounting Office, *Information Technology: DLA Should Strengthen Business Systems Modernization Architecture and Investment Activities*, GAO-01-631 (Washington, D.C.: June 29, 2001).

[39]GAO-01-525.

Monitoring and Oversight

Ensuring effective monitoring and oversight of progress will also be key to bringing about effective implementation of the department's financial management and related business process reform. We have previously testified[40] that periodic reporting of status information to department top management, the Office of Management and Budget (OMB), the Congress, and the audit community is another key lesson learned from the department's successful effort to address its Year 2000 challenge.

Previous submissions of the department's *Financial Management Improvement Plan* have simply been compilations of data call information on the stovepiped approaches to financial management improvements received from the various DOD components. It is our understanding that DOD plans to change its approach and anchor the plan in the enterprise architecture. If the department's future plans are upgraded to provide a departmentwide strategic view of the financial management challenges facing the department, along with planned corrective actions, these plans can serve as an effective tool not only to help guide and direct the department's financial management reform efforts, but also to help maintain oversight of the department's financial management operations. Going forward, this Subcommittee's oversight hearings, as well as the active interest and involvement of the defense appropriations and authorization committees, will continue to be key to effectively achieving and sustaining DOD's financial management and related business process reform milestones and goals.

In conclusion, we support Secretary Rumsfeld's vision for transforming the department's financial and business related operations. The continued leadership and support of the Secretary and other DOD top executives will be essential to successfully change the DOD culture that has over time perpetuated the status quo and been resistant to a transformation of the magnitude envisioned by the Secretary. Comptroller Zakheim, as the Secretary's leader for financial management modernization, will need to have the authority to make the difficult investment decisions involving the billions of dollars being spent on systems across the department. DOD business operations—people, processes, and technology—will have to be reengineered and stovepiped and internally focused approaches will have to be put aside. The past has taught us that well-intentioned initiatives will

[40]GAO-01-244.

only succeed if they are transparent and the incentives and accountability mechanisms are in place.

The events of September 11 and other funding and asset accountability issues associated with the war on terrorism, at least in the short term, may dilute the focused attention and sustained action that are necessary to fully realize the Secretary's transformation goal, which is understandable given the circumstances. At the same time, the demand for increased defense spending, when combined with the government's long-range fiscal challenges, means that solutions to DOD's business systems problems are even more important. As the Secretary has noted, billions of dollars of resources could be freed up for national defense priorities by eliminating waste and inefficiencies in DOD's existing business processes. Only time will tell if the Secretary's current transformation efforts will come to fruition. Others have attempted well-intentioned reform efforts in the past. Today, the momentum exists for reform. But, the real question remains, will this momentum continue to exist next month, next year, and throughout the years to make the necessary cultural, systems, human capital, and other key changes a reality? For our part, we will continue to work constructively with the department and the Congress in this important area.

Mr. Chairman, this concludes my statement. We would be pleased to answer any questions you or other members of the Subcommittee may have at this time.

Contacts and Acknowledgments

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Mr. SHAYS. Mr. Spinney.

Mr. SPINNEY. Thank you, Mr. Chairman.

Can you hear me now?

Before beginning, I would like to state for the record that I am presenting my own views. I am not representing any of the views of the Defense Department.

Mr. SHAYS. You're on this panel because of this reason. You're on this panel, as opposed to being a representative.

Mr. SPINNEY. I just wanted that in the record.

Mr. SHAYS. It is in the record, and we're delighted to have you.

Mr. SPINNEY. Mr. Lieberman's comment about the PPBS is particularly germane, in my view. The PPBS is the Planning, Programming and Budgeting System and is the major financial management system for the entire Department of Defense.

Basically, all your systems should feed into that data base, because that's the data base we use to try to provide a coherent plan for the future, and I don't think you can separate the financial management problems from the plan for the future and the budget now before Congress.

Could I have slide A, please?

Slide A shows the current situation before Congress. The vertical line is the link between the past and the future. The rising bar shows you how much money we're going to ask for; and, as you can see, most of that money was put into place during the summer program review last year before the war on terrorism started. The red ribbon on the top is the difference that occurred after September 11th.

Today's budget should accurately reflect the future consequences of those decisions. In other words, when you prove this year's budget, you're buying into that plan; and that plan should accurately reflect what you bought into. It should also reflect the consequences of past decisions. In other words, today's decisions should be linkable to the past.

Could I have the next slide, B?

This is the basic problem as I see it. We can't divorce the financial management problem from these links between the future and the past. The left-hand box has been accurately summarized. I basically agree with everything that's been said. The right-hand box is what I want to talk about today.

Our planning system—and I have studied this for years. I did my first analysis of this as an Air Force officer in 1973.

What happens is we have a structural bias to understate the future consequences of decisions. The easiest way to understand that is by looking at cost estimates for new procurement. It goes far beyond that, and I want to use that as an example. The end result is, as the program unfolds, production rates get cut back, we have continuing pressure to reduce readiness, our forces get older over time, infrastructure gets mismatched from a shrinking force structure and eventually pressure builds to increase the defense budget and we have sort of a boom-and-bust cycle. I want to use the F–18 as an example of how this process works to illustrate it.

Slide C, please.

This slide shows you the comparison between our plans for F–18 procurement and our actual production of F–18 procurement,

most of which took place during the large budget increases in the 1980's. The lines represent the plans. The bars represent what actually happened. What you can see is we progressively overestimated future production quantities, and that bias to overestimate continued year after year after year. This is a product of the Planning, Programming and Budgeting System. It's like a moving picture of it.

Next slide.

The next slide is an analogous slide for the procurement budgets that were associated with that production program. Now what is interesting here again, the lines represent the plans and the bars represent what was actually appropriated in terms of money to buy the planes in the previous slide. What this shows you is that we actually appropriated more money in the early part of the program than was initially planned. So the program stretch-outs on the previous slide can't be associated with budget cuts. We have program projection stretch-outs. That raises budgets. Well, that didn't happen here.

This is a very typical example, although it's clearer than most. That's why I'm using it.

We can use the production data and the budget data to calculate costs, which is shown on the next slide. I won't go into the construction. It's been validated by GAO audit. Basically suffice to say that the heavy line with the balls represents the actual average cost over time as a function of the total production produced. The lines are the analogous depiction for the plan. In other words, the lines are what we said would happen. And, as you'll see, I have a box that highlights preproduction cost estimates. They are way low. Costs on the F–18 went down. They just didn't go down as far as we said they would. In fact, the actual costs were twice as much as predicted. Now if you multiply these kinds of pressures by hundreds of programs, what you have is what—when Mr. Kucinich read that phrase in my report, metastasizing cancer inside the system.

The next slide shows how the overall FYDP changes over time. This is the boom-and-bust cycle that I talk about in more detail. The lines are all the FYDPs since it was introduced in 1961.

By the way, this chart is in current dollars. No way to remove inflation. What you see is, after Vietnam, we saw a gradual ratcheting up as programs grew in cost over time. And I'm sure you've all sat in hearings about weapons cost growth. This is what happens in the budget. You also have growing readiness costs in here as well, and eventually you buildup a head of steam and it leaps off into deep space.

Then we saw a retrenchment very similar to the 1970's, and now we see the beginnings of an expansion, which brings me to the crux of the point. If, in fact, we're on the cusp of repeating another episode like we did in the early 1980's and we can't account for what's about ready to happen, this is going to unfold over the next decade. At the end of this next decade you all know that's when the baby boomer is starting to retire and there's going to be all sorts of other pressures impinging on us. That's why I don't think we can take 8 years to solve this problem. We have to move out right now and try to anticipate these problems and put together a decisionmaking

process that can essentially sense these things ahead of time and avoid them.

The final part of my statement, which I won't go into here, basically describes a way I thought about doing this. There is no magic bullet, but it's a way that gets at these issues.

That concludes my statement.

[The prepared statement of Mr. Spinney follows:]

Statement by

Franklin C. Spinney
Staff Analyst, Department of Defense

Before

THE SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS AND INTERNATIONAL RELATIONS

COMMITTEE ON GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES

June 4, 2002

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to provide the Committee with my views on the financial management problems facing the Defense Department.

Although my appearance has been approved by my superiors, I am presenting personal views that do not reflect an official view of anyone in a position of authority in the Department of Defense or in the current Administration. They are, however, based on thirty-three years of experience, including over seven as an officer in the United States Air Force and twenty-six as a civilian in the Office of the Secretary of Defense.

In my view, the Defense Department's financial management problems cannot be divorced from the defense budget now before Congress. Moreover, this budget is really a point in a time continuum linking us to the past and to the future. Viewed from this perspective, the requirements of sound financial management become clear: Today's budget should reflect a sound appreciation of and account for the intended consequences of past decisions as well as the future consequences of current decisions.

The DoD's financial management problems can be summed up quite succinctly: *Both* links are broken. The historical books cannot pass the routine audits required by law and planning data systematically misrepresent the future consequences of current decisions. The *double breakdown* in these information links makes it impossible for decision makers to assemble the information needed to synthesize a coherent defense plan that is both accountable to the American people and responsive to the changing threats, opportunities, and constraints of an uncertain world.

My aim today is twofold: In Part I, I want establish a point of departure by describing the basic structure of the top-level financial management information system now used by the Pentagon's senior leadership to shape the Department's plans and control the evolution of our nation's defense policies. Then I will place the double breakdown in the context of this system, with emphasis on the breakdown in the link between the present

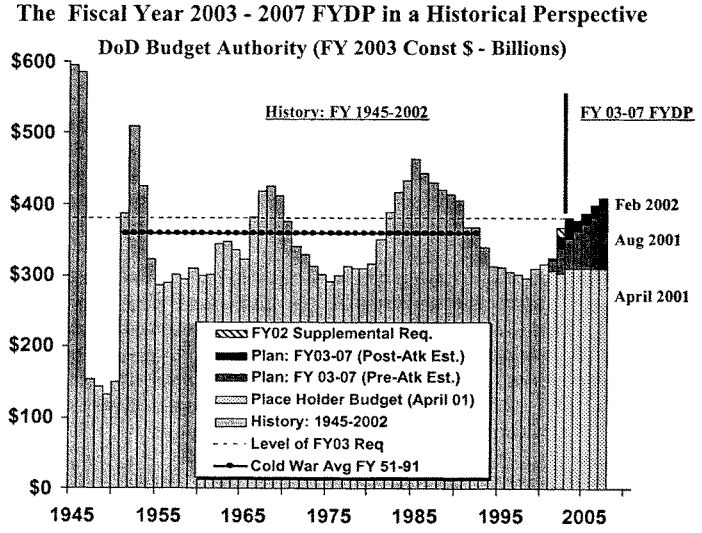
and future. In Part II, I want to submit for the record the broad outlines of a proposal for a program to produce the kind of information needed to resolve this crisis.

Part I

The PPBS, the FYDP Database, and the Link Between Ouput and Input

The budget before Congress is actually the first year of a comprehensive five-year budget plan known as the FY 2003-2007 Future Years Defense Plan or FYDP (pronounced 'fiddup'). This plan was produced over the last year by the deliberative procedures of the Planning-Programming-Budgeting System or PPBS. The PPBS is a step-by-step strategic decision-making process and is designed to link the threat assessments and the policy intentions of our political leadership via a national defense strategy to the thousands of detailed force structure, modernization, and readiness decisions which are needed each year to keep the Defense Department running coherently in the desired direction.

Slide 1 places the current FYDP in a historical perspective. Specifically, it shows how the new five-year plan compares to the history of past appropriations reaching back to 1945. Note that the distorting effects of inflation have been removed and all budget numbers are expressed in FY 2003 constant dollars.



Slide 1

The FY 2003-2007 FYDP calls for enormous increases in future defense budgets out to FY 2007. These budget increases have been justified as being necessary to fight the global war against terrorism that was triggered by the criminal attack on the World Trade Center and Pentagon last September 11. Yet Slide 1 shows that most of the budget growth was put into place by the PPBS before September 11.

The dotted line projected backward from fiscal 2003 makes it easy to compare the current budget request to past budgets as well as the average budget level of the entire Cold War, which is represented by the heavy black line. The dotted line tells us that the FY 2003 budget would be higher than that averaged during the Cold War, when America faced the threat of a nuclear tipped Soviet superpower instead of a criminal network of terrorists funded by fanatical anti-American Saudi millionaire. Only the budgets that paid for the Korean and Vietnam Wars and those of the Reagan Administration exceeded the request now before Congress. Nevertheless, this spring, the leaders of the military services told Congress the FY 2003 budget shortchanged their funding requirements by roughly $25 billion, according to Congressman Curt Weldon.[1]

Turning our attention to the future, the dark gray triangle topped by the black band shows how the defense budget is projected to rise to a level almost $98 billion higher in 2007 than the defense projection used by the Bush Administration in its so-called "placeholder" federal budget of April 2001 which, you will recall, was part of the package of financial calculations supporting the proposed tax cut (portrayed in Slide 1 by the light white bars). Note also that 82% of that $98 billion increase, or $81 billion, was produced during the summer program review in the Pentagon, between May and August of 2001. Nevertheless, this increase may not be enough. On May 3, Defense Secretary Rumsfeld ordered the services to study options for cutting back major modernization programs, because the Pentagon cannot afford all the weapons in the pipeline.[2]

The only part of the defense increase that can be directly attributed to the changed conditions brought about by the attack on September 11 is the thin black ribbon on top of the dark gray triangle. By any measure, this add-on is a tiny part of the total defense budget, and this increase may also not be enough. In April, the senior military officials claimed they needed to increase personnel end strength by 50,000, because our forces have been stretched thin by the global war on terrorism.[3]

Slide 1 may provide insight into the relative size of the FYDP and how it evolved, but it says nothing about what these expenditures will or will not buy. That requires a detailed analysis of its innards, yet there are already indications that these innards are unraveling.

Bear in mind, the goal of the PPBS was to link the threat assessments and the policy intentions of our political leadership to thousands of detailed force structure, modernization, and readiness decisions. Its end product – the FYDP – describes these decisions, and it does so with a huge table containing thousands of rows of accounting data. Each row of the FYDP table specifies a program element by laying out a five-year stream of detailed budget numbers for a specific function or activity.

The program elements are supposed to be the output-oriented building blocks of defense policy. The resource allocations (i.e., the tradeoffs) among them define their relative values or priorities. The entire table, therefore, is -- or should be -- a comprehensive statement of the priorities and tradeoffs used to shape our nation's defense strategy. Yet the ink was not dry on this table before pressures emerged to change the table.

The situation is complicated by the fact that these program elements do not correspond to the traditional input-oriented appropriation categories used by Congress to raise money for the armed forces. In fact, a single program element in the FYDP is likely to include more than one appropriation category in its money stream. For example, a program element for a component of force structure, like "F-15 Squadrons," could conceivably include the moneys from the R&D, Procurement, O&M, Milpers, and Milcon appropriations. Taken together, the data in this program element are the highest-level financial management information summarizing the past, present, and future states of the F-15 force (its size, its modernization, and its readiness).

The appropriations request the Pentagon sends to Congress re-tabulates the various components of the detailed program element data into the standard appropriations format. This transformation is conceptually straightforward and easy to do with computers, but it shifts the decision-maker's frame of reference to input categories. This shift can be a source of confusion which, in my opinion, is one reason why budget battles inside the Pentagon as well as between the Pentagon and Congress often degenerate into context-free food fights over appropriations inputs rather than policy-based deliberations over programmatic outputs -- the ongoing fracas over the Crusader howitzer being an excellent case in point.

Viewed from the programmatic perspective, the four outyears of the current FYDP (i.e., FY 2004-2007) are the Defense Department's definitive output-oriented statement of the future consequences of a Congressional decision to appropriate the details of the FY 2003 budget. The accounting data in these outyears tell the Secretary of Defense, the President, the Congress, and the American people what they can expect to buy and how much they will spend over the long term if they make a current decision to fund the FY 2003 budget. Yet there are already signs that this FYDP understates the true cost of the entire defense program.

The mass of detailed program element decisions in FY 2003-2007 FYDP are also linked to the past decisions by a complimentary program-element table of the Pentagon's past expenditures. This historical table makes it possible to understand how the individual program elements in budget request evolved out their counterparts in past budgets. The historical database has various forms of program element data reaching back to 1962.

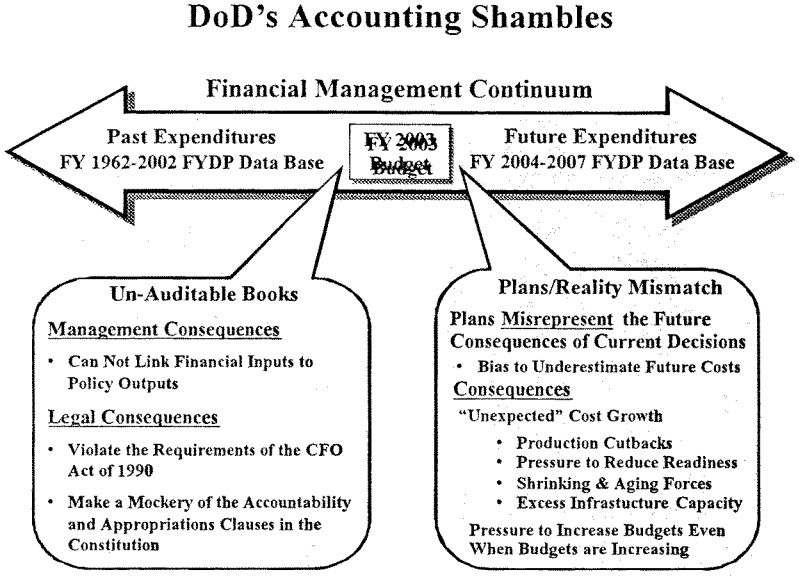
The historical data can be compared to data in past FYDPs to determine if the actual evolution of the defense program is the product of policy driven decisions. Such a comparison can provide valuable feedback to guide corrective action. It also would help us gage the reliability of the projections in the current FYDP. The past, present, and future times horizons of the FYDP database, therefore, should be able to provide the

information needed to understand and control the evolution of defense policies over time.

Taken together, the PPBS and the FYDP database are the central tools of financial management in the Department of Defense at the highest policy level. All the expenditure and budget planning data produced by the Department's various subordinate or specialized financial management systems should be consistent with and reliably rolled up into the FYDP's financial management information system.

With this background in mind, I will now discuss the double breakdown of Defense Department's financial management systems.

Slide 2 places the Defense Department's financial management problems in context of the FYDP's time continuum. The left box refers to the breakdown in the link between the present and the past, and the right box refers to the breakdown between the present and the future. The next two subsections describe the implications of each breakdown.



Slide 2

The Breakdown Between the Present and the Past

There can be no dispute over the contention that the link connecting the present with the past is broken. One needs only to glance at the pile of reports produced by the General

Accounting Office and the Defense Department's Inspector General as well as the final report of Mr. Stephen Friedman's financial transformation panel (Transforming Department of Defense Financial Management A Strategy for Change, April 13, 2001) to appreciate the rich variety of detailed information about the incredibly complex nature of the Defense Department's bookkeeping shambles. Yet within that variety, these reports converge on two central conclusions.

First, the Defense Department's accounting systems do not provide the information needed to relate financial inputs to policy outputs. The Friedman report says, for example, these systems do not provide reliable information that "tells managers the costs of forces or activities that they manage and the relationship of funding levels to output, capability or performance of those forces or activities."[4]

A logical consequence of this conclusion is that unreliable accounting information makes it impossible to link the intended consequences of past decisions to the defense budget now before Congress. Such a conclusion is tantamount to saying it is not possible to determine whether or not the internal activities of the Defense Department are matched to the external requirements of its environment.

Second, these reports agree that the Pentagon's bookkeeping systems do not comply with legal requirements of the Chief Financial Officers (CFO) Act of 1990. This conclusion goes well beyond the principles of sound financial management and strikes at the soul of the Constitution.

The CFO Act requires government agencies to pass annual audits of the links between an executive agency's expenditures and the legally enacted appropriations authorizing those expenditures. This audit requirement is intended to sharpen the teeth of the Appropriations and Accountability Clauses in the Constitution, Article 1, Section 9, Clause 7, which says,

> "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time."

This clause, as we all know, assigns the power of the purse to Congress, and it does so with language that denotes (1) a clear and absolute prohibition on spending (i.e., "No Money") and (2) an all-encompassing requirement for accountability (i.e, "all public Money"). The sweeping construction allows no room for exception. Nor is this construction an outdated artifact of arcane 18th Century language. According to the eminent constitutional scholar Professor Edward S. Corwin, this clause is Congress's most important check on the actions of other branches of government in the Constitution's entire scheme of checks and balances.

It is therefore clear that a finding of non-compliance with the CFO Act is a dagger aimed at the heart of American constitutional theory – namely, the idea of making the government accountable to be people via a legal system of checks and balances – a system, I might add, that everyone in the federal government has sworn freely and without reservation to uphold, protect, and defend.

In conclusion, the breakdown in the link between the past and present carries with it profound managerial, constitutional, and moral implications. The historical accounting shambles *is* a crisis, and it must be rectified as soon as possible, but this is only half the story: We face a double crisis, because the accounting systems that link the present budget to the future are also a shambles. I call this the Plans/Reality Mismatch

The Breakdown in the Link Between the Present and the Future: The Plans/Reality Mismatch, the Defense Power Games, and the Boom and Bust Cycle of Decay.

The Pentagon has produced a new FYDP each year since the PPBS was introduced by Defense Secretary McNamara in 1961. Each of these FYDPs was derived in theory from a defense strategy based on an appreciation of threats to our security and the political leadership's policy intentions. Each FYDP, therefore, should be a comprehensive numerical portrait of the defense policy made by the Secretary of Defense and approved by the President at a given point in time. The data in each FYDP's predictions are also an historical record of what the Defense Department's said would happen over the long term if Congress appropriated the funds to pay for the first year of that plan. This historical record makes it possible to compare the pattern of intentions (i.e., the "Plans") to the pattern of the pattern of actual behavior as documented by the historical FYDP database (i.e., the "Reality"). For reasons that will become clear, I call this kind of comparison the Plans/Reality Mismatch.

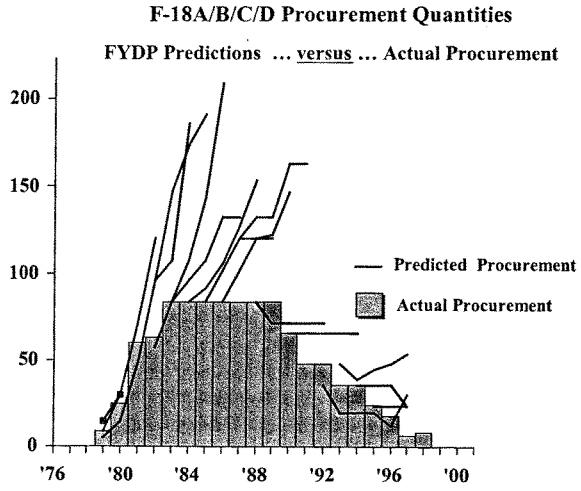
Bear in mind, no one can predict the future with 100% accuracy, but if the PPBS is an unbiased decision-making process, the predictive errors in the succession of FYDPs should be randomly distributed, even if the historical record is not accurate. If, on the other hand, the distributions of predictive errors are systematically skewed, we can conclude that behavioral biases are shaping the real long-term decisions, and the first year of the FYDP is masquerading under false pretenses. Moreover, a repetition of these biases year after year would be evidence that this a product of habitual behavior.

State-of-the-art data processing technologies makes it possible, at least in theory, to perform this kind of comparison across many FYDPs for any program element or aggregation of elements in the defense budget. In practice, such an analysis is complicated by many intractable factors. On the one hand, there will never be unambiguous output metrics for parts of the program elements in the FYDP data base, like the contribution of the all important moral factors to measurements of a unit's readiness for combat or a global measurement of a weapon's effectiveness, which is always scenario dependent. On the other hand, it is easy to quantify the first order outputs of procurement decisions (i.e., the number of items procured) and the first order inputs of procurement decisions (i.e., the budgets and unit costs for each item). So a plans/reality mismatch analysis is quite straightforward for the procurement data in the FYDP's program elements.

To this end, we combined the last twenty-six procurement annexes of the FYDPs into a 90-megabyte database (FY 1976 thru FY 2001 – the most recent data has not yet been included). This database permits a planner to examine how accurately the cost, quantity, and budget predictions of our modernization plans matched up to what really happened (in inflation adjusted dollars). The methodology underpinning these comparisons was validated by a GAO audit in 1996, made at the request of Senators Grassley and Roth.[5] The next three slides are a typical case study of these comparisons and will be used to illustrate the biased nature of the information linking the present with the future.

In the mid-1970s, the Navy's tactical airpower (tacair) program faced an aircraft aging crisis not unlike that faced today. The only two airplanes in production -- the F-14 and the A-6 -- were too expensive to buy in sufficient quantities to maintain the Navy's goal of an average age of 7.5 years for the tacair aircraft in its inventory. The Navy faced the possibility of not having enough airplanes in the long term to equip its aircraft carriers with modern full-strength tacair squadrons. The F-18 program became the centerpiece of a strategy to solve the crisis. The idea was to compliment the low production rates of the F-14s and A-6s with higher production rates of lower-cost F-18s. This plan became part of a larger modernization policy known as the "High-Low Mix," a snappy but meaningless soundbyte that unfortunately remains with us to this day. The next three slides show how this policy came unglued with the passage of time.

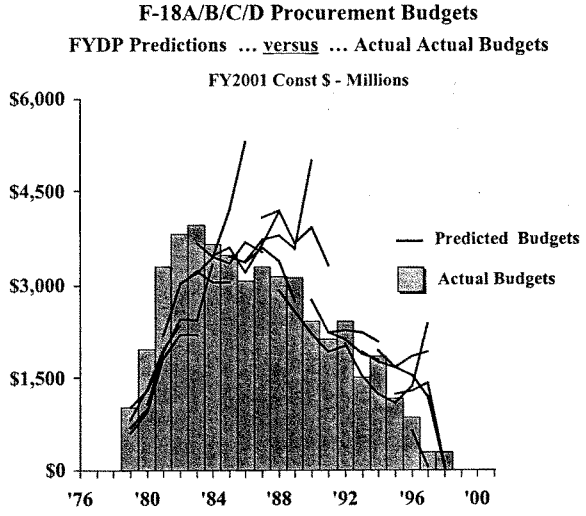
The Plan/Reality Mismatch: Production. The Navy's F-18A/B/C/D tactical fighter began development in the mid 1970s and entered production in 1979. Slide 3, which compares planned purchases to actual purchases, shows the result.



Slide 3

Each "line" in Slide 3 depicts a separate FYDP's prediction of the number of F-18s that would be purchased in each of its future years, whereas the "bars" portray actual number of F-18 purchased each year. The Defense Department planned to increase the F-18's production rate to somewhere between 150 and 200 F-18s per year, but actual production never exceeded 84 per year, notwithstanding the largest peacetime defense budgets in history. Moreover, the Defense Department maintained its grossly biased vision of the future production until the FY 1987-1991 FYDP (i.e., the line ramping up from the 1986 "bar"), long after it should have been clear that the production plan was a pipedream.

The Plans/Reality Mismatch: The Program Budget. The conventional wisdom is that production cutbacks, like those in Slide 3, cause cost growth, but our data shows that this is generally not the case for programs in the early years of their production life cycle, as was the F-18 in the first half of the 1980s. Slide 4 continues the example with a Plans/Reality Mismatch diagram that compares the F-18's predicted budgets to its actual budgets. Like Slide 3, the "lines" represent the FYDPs while the "bars" portray the actual budgets. Bear in mind, the effects of predicted and actual inflation have been removed and all numbers are expressed in FY 2001 dollars.



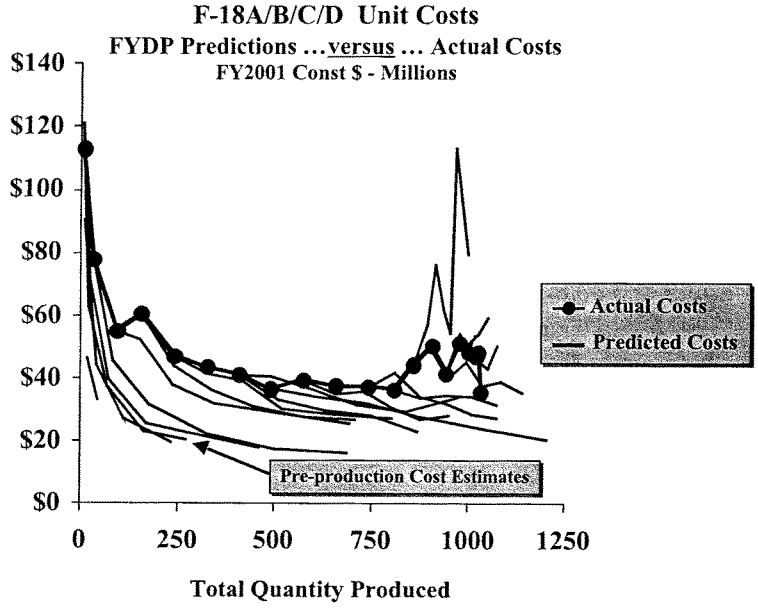
Slide 4

Slide 4 reveals that the actual procurement budgets in the historical FYDP data base exceeded those predicted by the succession of FYDPs for the first six years its of F-18's production run – i.e., 1979 to 1984. So, money was being added to the F-18 production program while its production rates were cut back drastically from intended levels. This means cost growth must have caused the cutbacks not budget cuts. Slide 5 addresses this

issue, and it gets to the heart of the biases creating the plans/reality mismatch and the breakdown in the financial management information linking the present to the future.

The Plans/Reality Mismatch: Unit Costs. The information in our database shows that the long-range cost predictions made during the development phase (i.e., pre-production) and the early production stages of a major weapon's life cycle almost always understate its eventual production costs by large amounts. The dangers posed by this phenomenon are particularly relevant today, because the current FYDP contains an unprecedented bow wave of programs in the development or the early production pipeline.

The F-18 is a typical albeit unusually clear example of the bias to grossly underestimate the unit costs of a weapons program in the early stages of its acquisition life cycle. The production data in Slide 3 can be divided into the budget data in Slide 4 to calculate the predicted and actual unit production costs. All this data can be placed on one chart, if cost is plotted as a function of cumulative production rather than by year. Slide 5 shows the result. It relates the average annual cost of an F-18 (on the vertical axis) to the total number produced (on the horizontal axis). The average annual costs can be thought of as an approximation of each additional F-18 produced or what an economist would refer to it as "marginal cost".



Slide 5

The heavy black line with the "ball" markers shows how the F-18's *actual* costs changed as the total number produced increased. This portrayal is known in the Pentagon and the defense industry as a *learning curve*. The thin lines show the *planned* learning curves contained in each of the five-year plans (FYDPs). All costs have the effects of inflation removed and are depicted in constant FY 2001 dollars.

Slide 5 should be read as follows: We know from slides 3 and 4 that the first year of F-18A's production was 1979; this is denoted by the leftmost "ball" in Slide 5. Moving to the right, each successive "ball" represents a successive year, and the horizontal distance from the preceding "ball" represents the annual purchases for that year.

Perhaps an example will make this clearer: The first seven years of production take us from FY 1979 to 1985 and are depicted by the left-most seven "balls." The horizontal distance covered by the heavy black line in Slide 5 indicates we bought a total of about 400 F-18s over these seven years. The downward slope of the heavy line shows that *actual* unit costs declined from about $113 to $41 million per copy during this period. So, as would be expected, marginal costs declined as production increased. But the important point to note is that these costs did not decline as fast and as far as predicted by a wide margin.

This can be seen if we compare the actual costs to the F-18's *predicted* costs (i.e. the thin lines). Note how the earliest plans (the thin lines furthest to the left) are far below the solid black line. Slide 5 tells us that the early plans predicted that the 400th F-18A would cost about $20 million, but it actually cost about $41 million. So, we have a mismatch between plans and reality, and even though actual costs declined from $113 to $41 million per copy between 1979 and 1985, the 400th F-18 still cost twice a much as predicted by the costs in the pre-production estimates that were used to justify the High-Low Mix modernization policy. Several points should be noted: First, most of the cost growth occurred in the first six years of production (i.e., between 1979 and 1984) – precisely when money was being added to the predicted budgets (Slide 4). Second, the cost growth in Slide 5 associated with the budget cutbacks made after 1986 (Slide 3) was far less disruptive than the cost growth that occurred in the pre-production stage of the F-18's acquisition life cycle, when money was being added to the program. Finally, the mismatches continued year after year, notwithstanding feedback that actual costs were exceed ing predicted costs; suggesting habitual behavior was driving the planning process.

The Defense Power Games. A repetitive bias to grossly understate future costs is typical of programs in the early stages of their acquisition life cycles. Our database contains a large number of programs exhibiting patterns similar to those of the F-18. In part, this bias is a natural result of uncertainty – as weapons get more complex, it becomes more difficult to predict what they will eventually cost. But more importantly, in my opinion, the bias reflects the first step in an unbiquitous two-step bureaucratic gaming strategy, known as *Front Loading* and *Political Engineering* . These strategies are explained in detail in a report that can be down loaded from the internet.[6]

Brutally stated, the aim of this gaming strategy is to turn on the money spigot and lock it open.

Front loading is the art of planting seed money today while downplaying the future consequences of a decision to spend that money. While it takes many forms, the most well known form is the so-called "Milestone II Buy-In," a deliberately "low-balled" estimate of future costs made to obtain a Milestone II approval in a weapons acquisition program. A Milestone II approval is crucially important, because it allows an acquisition program to move into concurrent engineering and manufacturing development (EMD). Once EMD is approved, the defense contractor can begin to "invest" contract dollars (i.e., tax dollars) in building a geographically distributed production base as well as a nationwide network of suppliers. The EMD decision, in effect, gives the contractor permission to use public money to build his political protection network by systematically spreading subcontracts and production facilities to as many congressional districts as possible. This spreading operation is the second step in the gaming strategy and is known as *political engineering*.

The goal is to raise the political stakes before the true costs of the front-loaded program become apparent. By the time these costs emerge, as they clearly did in the case of the F-18, the series of sequential adjustments in the succession FYDPs have bought enough time and desensitized decision makers to the effects of additional production cutbacks, while the political cost of a fundamental redirection (i.e., termination) has become prohibitive. So, decision-makers on both sides of the Potomac take the easy way out: they cut back production rates to reduce total costs in order to protect the jobs and profits of their constituents. Viewed in the context of the defense power games, production stretch-outs, like those in Side 3, were a predictable, indeed inevitable, consequence of a decision to front load the F-18 into the budget in the late 1970s and early 1980s.

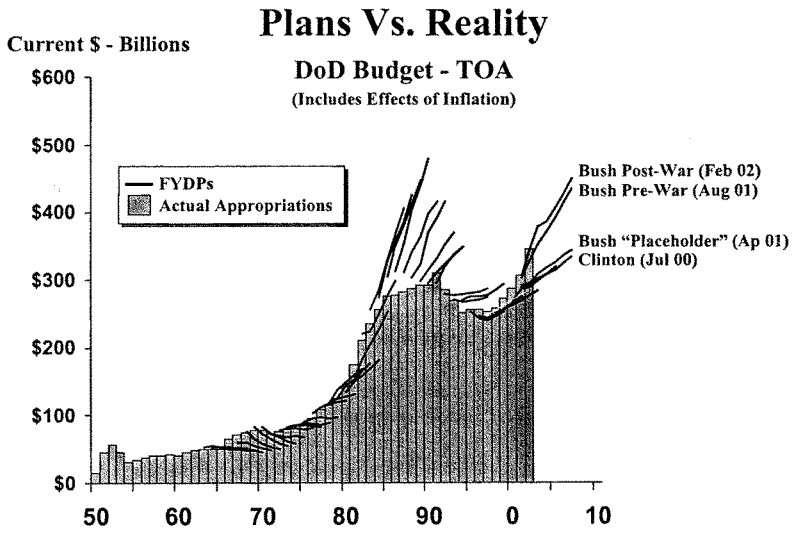
While these power games may work to get programs started in the short term, they create a brain lock that produces a vicious cycle of decay over the long term.

The Boom and Bust Cycle of Decay. The "low-balled" cost projections made during the pre-production phase of a weapon's life cycle permit too many new programs to get stuffed into the out years of the FYDP. This sets the stage for repeated increments of cost growth and ever rising pressure to grow the entire defense budget.

But the budget cannot grow as fast as the unit costs of front-loaded programs increase and eventually a retrenchment sets in. At the same time, the effects of political engineering paralyze decision-makers and induce them to absorb the cost growth through inefficient expediencies, like repeated production stretch-outs in lieu of terminations. The lower rates of production naturally decrease the rate of inventory turnover, which increases the age of weapons and makes them more expensive to operate, thereby driving up the operating budget. But the increasing age of the equipment also increases the pressure to transfer money from the operating budget to the modernization budget, while the rising cost of operating the older weapons makes it more difficult to do so.

Consequently, cost pressure builds up rapidly over time, and a kind of boom and bust cycle is born: Budget retrenchments like those in the 1970s and 1990s make problems worse, which are followed by budget expansions that naturally overreach when the front loaders and political engineers plant the seeds for anther round of outyear underfunding problems, as happened in 1980s. Over time, the cycle of decay takes the form of the so-called death spiral of shrinking combat forces, decreasing rates of modernization, aging weapons inventories, with the rising cost of operations creating continual pressure to reduce readiness.

Slide 6 portrays the outer manifestations of this boom and bust cycle. It compares the history of the defense budgets predicted by the FYDPs (the lines) to the history of actual budgets (the bars). Note that Slide 6, unlike the data in Slide 1, *includes* the effects of inflation; this is necessary because of data limitations.[7]



Slide 6

The pattern of mismatches in Slide 6 suggests a dynamically unstable system capable of steadily increasing growth pressures ending with grotesque overreaching. A comparison of the 1970s to the 1990s sheds light on its underlying dynamics and places the current burst of growth in perspective.

The 1970s, like the 1990s were periods of post war budget retrenchments and reduced growth, producing a general pattern of low rates of weapons production, aging forces, and emerging readiness problems. But these periods were alike in another way: Each was characterized by the front loading of a substantial number of new high-cost

modernization programs into the development pipeline. The programs, being in the early stages of the acquisition cycles, had uncertainties like the F-18 example discussed above. This created a growing bow wave of unspent balances in the modernization accounts during each decade.

Moreover, in each period, the growing readiness problems coupled with the rising cost of operations precluded a funding strategy that shifted substantial resources from the readiness accounts to the modernization accounts. Consequently, as each decade progressed, the pressure to increase the defense budget increased, and FYDPs were gradually ratcheted upward to accommodate the growing internal pressure (the effects of high inflation added to the pressure in the 1970s but not in the 1990s). The internal pressure built up in the 1970s exploded in the 1980s and the FYDP predictions leaped away from any resemblance to reality. The rapid growth of the most recent FYDP projections in Slide 6 suggest that the pressure is again building up rapidly and the internal dynamic may be poised for yet another round of explosive overreaching.

The exploding growth of internal pressure is also suggested by the data in the most recent Selected Acquisition Report (SAR) sent to Congress. The SAR describes the funding status of most of the major acquisition programs in the modernization pipeline. Its data includes information on each program's prior expenditures, its current budget, and the amount remaining to be spent (i.e., the unspent balance). The ratio of a program's unspent balance to its current budget tells us how many years it would take to buy out the program, if spending remained at the current level and there was no cost growth. A rising ratio would indicate a shift to new programs (and a preponderance of "low-balled" pre-production cost estimates) in the SAR mix, which implies greater uncertainty, and a growing bow wave, both of which would increase the internal pressure to grow the defense budget more rapidly over the long term. In September 1971, for example, that ratio equaled 4.6 years. By 1979, just prior the budget's liftoff in the 1980s, the ratio stood at 8.1 years. According to the data in the most recent SAR (December 2001), that ratio now stands at 18.1 years (and that does not include an estimate for the unspent balances in the National Missile Defense Program!), with the unspent balance being the largest on record.[8]

Interim Summary

Let me now bring the entire discussion of Part I together. We can think of the Defense Department as a living goal-seeking organism. The procedures of PPBS are the tools used by the collective brain to set goals by matching the organism's inner workings to the threats, opportunities, and constraints in its external environment. The FYDP, being the end product of that brain's activities is therefore the essential source of financial management information that describes this matchup.

But the FYDP's description is fatally flawed. The information in the historical FYDP database cannot pass an audit and the data used in its planning projections are unreliable, arbitrary and, in important cases, systematically biased to grossly understate the future

consequences of current decisions. These problems were avoided during the retrenchment of the 1990s, while the internal pressure built up rapidly in the latter half of the decade, and there are now signs that the PPBS may be about to go unstable like it did in the 1980s in reaction to the retrenchment of the 1970s.

Consider, please, the dire implications of this breakdown: Without reliable information, there can be no confidence that the required matchup between the Defense organism and its environment has been or will be achieved. When such a condition of uncertainty persists, the interaction of chance with necessity guarantees that it is only a matter of time before dangerous mismatches creep insensibly into the relationship between organism and its environment. When this occurs, the unreliable information in the database creates a kind of virtual reality that disorients decision makers, yet keeps them busy, thereby blocking corrective action, while the internal activities shaped by their decisions become progressively disconnected from and vulnerable to the threats and constraints in the real world.

Moreover, without decisive action to correct the source of the disorientation – i.e., the corrupted information – the disorientation will grow worse over time, leading inevitably to a growing sense of confusion and disorder that feeds back into and magnifies the disorientation even further. Eventually the breakdown in the goal seeking process will produce paralysis, and the activities of the organism will be directed more by inner workings of its constituent factions than by the requirements of the environment. Naturally, such a self-referencing process would become far more dysfunctional if the external environment changed suddenly and unexpectedly, as did the national security environment in the 1990s.

The bottom line: we face crisis that will take extraordinary action to resolve. The next section is a strawman proposal for building a strategy that works in the real world of uncertain threats, changing opportunities, and constrained resources.

Part II

Teach the Pentagon to Think Before It Spends

The FYDP is a strategic vision of the future, yet it does not account for the future consequences of current decisions. This kind of planning is by no means a new phenomenon in the Pentagon. Politicians and defense intellectuals have complained for years that the Pentagon cannot determine priorities because it has no strategy. The legislation passed by Congress in 1996 mandating a Quadrennial Defense Review was but one example of this long-standing frustration. Nevertheless, in one strategic review after another, the critics have recommended and defense planners have executed the same step-by-step procedure to solve the strategy conundrum:

1. Identify national goals and the threats to these goals.
2. Determine the strategy to counter the threats.

3. Determine the forces needed to execute the strategy.
4. Determine the budget needed to build and maintain these forces.

That this Cartesian procedure cannot solve the strategic puzzle ought to be clear from the recurrent calls for yet more strategy reviews. [9] While this mode of thinking is not a direct cause of the readiness, modernization, and bookkeeping problems discussed above, I believe the formulaic determinism of this procedure shackles our minds and prevents us from realizing a solution to these problems. This becomes clear when one examines how the logic underpinning this chain of dependencies prevents an interaction with the environment.

In theory, each step of the four-step procedure depends on the preceding step *but* is *independent* of the subsequent step. *Strategy* is the key link in this chain; it ties our relations to the outside world (goals and threats) to our internal conditions (forces and budgets). But it is wrong to think that strategy depends only on external factors, like goals and threats and is independent of internal conditions.

The fatal flaw in the logic of the PPBS procedure becomes apparent if one applies the four-step formula to a simple military problem. Let's assume a battalion commander receives a "mission order" to counter a threat on the flank of his division. Under the concept of mission orders he is told what to do but not how to do it. He therefore needs to formulate a strategy for accomplishing his mission. If he used the PPBS method to solve his "strategic" problem, he would define his strategy *before* he examined how personnel or materiel limitations might shape or limit his maneuver and fire options. His operational plan, for example, would not be affected by the fact that one-third of his battalion had been wounded in a previous engagement and the other two thirds were short of ammo. This is nonsense.

In the real world, *strategy is the art of the possible*, and any strategic decision-making procedure that ignores how one's internal constraints might limit or shape what is possible is a contradiction in terms.

A decision-making strategy *should* link our relations with the external world (goals and threats) to our internal conditions (the constraints of forces and resources). A biologist would view strategic planning as a selection process that harmonizes the internal structure of the organism with the demands of its environment. One side of the link does not uniquely determine the other, but each simultaneously feeds back on and shapes the other. The environment shapes the organism while the organism shapes the environment. Like evolution, a strategic decision-making process should be a creative process of *combination* and *selection* in an ever-changing, co-evolving domain consisting of external threats and opportunities on the one hand and changing internal structures and limitations on the other. The shaping effects of positive feedback in this interaction make strategic planning a nonlinear, non-sequential mental activity.[10] That is one reason why intuitive behavior is so important on the battlefield.

Viewed from this perspective, strategic decision-making is a *synthetic* activity and is by its nature simultaneous, constructive, creative, and adaptive.

Compare this richness of this view to the sterility exhibited by the four-step process used in the PPBS. Its rigid procedure is an *analytical* recipe for a *dissection* that follows a predictable, sequential, non-adaptive path. By its nature, it is not creative, which is the main reason why repeated strategic reviews always produce a plan that protects the status quo. The analytical elegance of the recipe may appeal to intellectuals housed in Cartesian towers, but the primitive assumption that strategy uniquely determines forces and budgets, in effect, presumes resources (money) are unlimited.

In the real world, where messy bureaucratic conflicts bubble up out of a clash of competing agendas, this kind of *unconstrained* thinking provides no incentive for making the hard decisions needed to discover a harmonious set of priorities among incommensurable but nevertheless competing options. Unconstrained thinking simply adds things together into unaffordable wish lists.

Furthermore, by ignoring internal constraints like resource limitations, our strategists have abdicated their responsibility for hard decisions. That puts the onus on others to make the real decisions -- the bean counters, budgeteers, and porkbarrelers. These people have different agendas — as evidenced by the fact that recent votes in Congress suggest that preservation of jobs is now the real goal of our nation's defense "strategy."

A strategic planning process should *discover* priorities by systematically exploring the interplay among the uncertainties surrounding the external threats and opportunities, on the one hand, and those uncertainties surrounding our internal structures and constraints, on the other. The following proposal sketches out a *combination-and-selection* process that explicitly addresses the co-evolving essence of strategic planning. Rather than viewing priorities as an input, which is another way of saying we start with answer, the following proposal views priorities as an output, or more precisely, it views priorities as an *emergent property* of a complex adaptive tradeoff process.

Strategic Planning as a Complex Adaptive Process - Theory:

By far, the most important internal constraint shaping the evolution of our military capabilities is the perpetual budget squeeze. Since this squeeze is a consequence of habitual behavior patterns that produce an economic relationship wherein *costs always grow faster than budgets,* a necessary condition for a competent decision-making activity is to make the long-term consequences of this asymmetry evident *before* decision-makers lock themselves into a given course of action. But a requirement to make the long term consequences of current decisions visible before the fact embodies a necessary pre-condition: Reliable information.

Job 1, therefore, is to fix the Pentagon's accounting problems, or at least reduce them to a acceptable level.

Fixing the books is not sufficient to produce a sound strategy, but it is self-evident that a more reliable description of our internal conditions, as well as the future consequences of changes to those conditions, would give planners the wherewithal to better understand the strengths and weaknesses of a given defense program in terms of its perceived matchup, or mismatch, with external reality.

The greater knowledge accompanying a more accurate description of our readiness and modernization problems, combined with state-of-the-art computer software technology, would make it possible for planners to understand how internal structures and capabilities of our military forces would change over a range of long-term budget scenarios—from optimistic to pessimistic. Under the different constraints imposed by each scenario, planners could determine the marginal effects of different force structure combinations in terms of achieving goals and neutralizing threats. By using a trial-and-error process of combination (which unleashes creativity and imagination) and evaluation (which uses testing and logic to discipline the imagination), planners could maximize strengths and minimize weaknesses of alternative combinations in order to gradually select (i.e., evolve) the most capable force structure option within the constraints of each given budget scenario. In so doing, planners would use their judgment to discover priorities (which are a reflection of the opportunity costs of *incommensurable* capabilities) by evolving the least painful program cuts as they move from higher to lower budget levels. The iterative process of combination and evaluation would also identify the best way to add programs, should the budget come in at higher levels.[11] By disciplining the selection process in this way, priorities – or core values – would *emerge naturally* out of a free competition in a marketplace of ideas.

Contingency planning and sensitivity analyses are common enough in war planning and business planning; there is no reason why they can not be done for defense program planning. Three phases of operation are needed to translate this abstract idea into concrete action. The first phase cleans up the books, the second phase constructs service level contingency plans, and the third phase synthesizes the service-level plans into a comprehensive Defense Department contingency plan.

Phase I: A Crash Program to Clean the Books

- **Fund the War on Terrorism on a "*Pay as You Go*" Basis**
- **Freeze the Core Program to Clean Up the Books**

We have seen that DoD's annual budget, as submitted to Congress, is the linchpin of an accounting continuum (the FYDP database) reaching backward in time to record actual expenditures and forward for five or six years to record future expenditures. Looking backward, the coherency of a defense strategy (and its supporting force structure, modernization and readiness levels) depends in part on the consequences of past expenditures. But the auditing problems revealed by the General Accounting Office and the Defense Department's Inspector General and the Friedman Report prove we cannot link past expenditures to today's budget/policy decisions.

The Plans/Reality Mismatch shows that future years of the FYDP database are also disconnected from the budget. The case study of the F-18 (Slides 3-5) is but one example of hundreds of FYDP/reality mismatches evident over the last twenty-six years. At the macroscopic level (Slide 6), these mismatches have created a boiling programmatic soup in which "low-balled" cost estimates breed like metastasizing cancer cells throughout the entire defense program. Biased numbers hide the future consequences of current policy decisions, permitting too many programs to get stuffed into the "outyears" of the long-range budget plan. This sets the stage for unaffordable budget bow waves, repeating cycles of cost growth and procurement stretch-outs, decreasing rates of modernization and older weapons, shrinking forces, and continual pressure to bail out the self-destructing modernization program by robbing the readiness accounts.

The end of the Cold War in 1990 provided a unique opportunity to take decisive action without jeopardizing our national security, but that opportunity was squandered over the next decade. And now the open-ended war on terrorism makes the required fix far more difficult.

But the war should not be used as an excuse to live with the status quo. To be sure, a decisive correction will be more painful today than it otherwise might have been, yet the readiness and modernization problems that emerged in the late 1990s, together with the exploding bow wave, cry more urgently for action to put the Defense Department on a more sustainable pathway into the future. Moreover, the crisis in intensified by the fact that we must get our house in order before the demographic time bomb of retiring baby boomers starts sucking money out of the federal tax base early in the next decade. To be decisive, the military services *must* first produce better decision-making information. It will take at least a year to begin the necessary book-cleaning operation, yet during that time, we must provide the military with resources to fight the war on terrorism.

The President, the Secretary of Defense, and the leaders of Congress should announce that, henceforth, the war on terrorism will be financed on a *pay-as-you-go* basis, with special requests made to Congress at appropriate intervals using the instrumentalities of supplemental budget requests. While this policy may seem unorthodox at first glance, the black ribbon in Slide 1 and the ongoing use of war supplementals suggest that the cost of the war is simply being added to the core defense program. War financing is already evolving on a pay-as-you-go basis as a practical matter of fact. This recommendation would simply extend a formal recognition to this fact. Moreover, the comptroller organizations in Office of the Secretary of Defense and the military services should set up special war financing branches to prepare the supplemental requests on a standardized basis. The pay-as-you-go procedure would have the added benefit of facilitating informed debate over the course the war on terrorism by making its costs more evident to the President, the Secretary of Defense, the Congress, and the American people.

In parallel, with questions of war financing now off the table, the President and the Secretary of Defense should immediately stop the ongoing FY 2004-2009 budgeting cycle and order a *one-year PPBS freeze* at the FY 2003 spending level or whatever budget level Congress appropriates for the FY 2003.

The purpose of the PPBS freeze is to buy the time needed to begin scrubbing the books. During this period, decision-makers in the Defense Department should strive continually to maintain or increase their flexibility to make future decisions (which will be needed in Phases II and III). To this end, they would make no new long-term contractual commitments during the program freeze. All acquisition milestones would be postponed, but existing programs, like the F-22, would continue at their current level on a "work-in-process" basis. On the other hand, decision makers would proceed with any actions that would increase the Defense Department's flexibility or adaptability into the future, like planned terminations, cutbacks, or base closings. Finally, they should remove special-access clearances for all programs, except those intelligence programs requiring protection of sources and methods. Black clearances stifle accountability, they increase costs, and they hide unprincipled behavior. Doubters should study the Navy's A-12 debacle, in which the contractors used the government's illegal behavior as an excuse for their failure to perform.[12]

Obviously, a program freeze will be disruptive and create economic inefficiencies in the short term, but unfortunately, that is the price leaders must pay now to obtain greater efficiency and strategic coherence in the long term.

While programs are frozen, the audit agencies of the Defense Department will undertake a maximum effort to do comprehensive financial audits of the expenditure control system, the FYDP database, and the assets assigned to each organization. One of their main goals would be to build a solid foundation for assembling a DoD-wide double-entry accounting system for tracking transactions, matching transactions to appropriations, and building an effective management accounting system so decision makers have the wherewithal to know what is going on inside their own organization. At the same time, war planners would commence a comprehensive readiness audit of current condition in each military service (including the real factors affecting morale, retention, training, doctrine development, and material condition). Using the more realistic cost numbers produced by the financial audits, each military service would then build a new FY 2004 to 2009 high-readiness baseline program by re-pricing the procurement and O&M programs in the approved program (i.e., the existing FY 2003 to 2007 program, adding in any un-funded requirements – see below) that was submitted to Congress in February 2002.

Taken together, these re-priced budget estimates would become the new DoD baseline budget scenario, which will require substantially larger budgets than the FY 2003-2007 FYDP approved by the President sent to Congress. The stage is now set for Phase II.

Phase II – the Construction of Component Planning Options:

In Phase II, Planners in each military service and independent defense agency would use the more reliable information produced by Phase I to as a basis for examining how the internal capabilities and structures of their service would change over a range of optimistic to pessimistic budget scenarios (notional scenarios are defined at the end of

this section), assuming each service's historic share of the total defense budget remained constant in each scenario. These shares will be subject to change in Phase III, but they are necessary in Phase II to get the process started.

The objective of Phase II is to discover the parochial priorities of each military service in the context of that service's capabilities and worldview, according to the theory of combination and selection outlined above.

To this end, military planners in each service would be free to construct their most effective force package within each given budget scenario by maximizing its strengths and minimizing its weaknesses, while conforming to that scenario's overall resource constraints. Service planners would be *free* to use their parochial perspectives to define the threats they will face. The only restriction on that definition would be a requirement to classify each threat guiding their planning options according to the taxonomies of Second, Third, and Fourth Generation Warfare. A general introduction describing these taxonomies can be found on the web.[13] This generational classification in necessary to establish a common doctrinal frame of reference for evolving and evaluating the global syntheses of Phase III and ensuring proper resource allocations

Subject to this restriction, planners in each service would be free to use their own perspectives and judgment to shape and identify preferred force structures (together with the supporting modernization strategies and readiness states) in a way they think best addresses the threat uncertainty. By constraining their planning options to each budget level, service planners would have to evolve a selection process that naturally identifies opportunity costs and their own service's parochial priorities by identifying the least painful programmatic adjustments as one moves from higher to lower budget levels and the most beneficial adjustments as one moves from lower to higher budget levels. Each military service would conclude the sensitivity analyses of Phase II by producing a comprehensive written net assessment of the force package selected for each budget level. Such a net assessment would identify the long-term military consequences (i.e., the preferred strategy, strengths, weaknesses, risks, and opportunities) of the force structures, together with the supporting readiness states and modernization strategies for each package. The final product at each budget level, together with the net assessments and the common taxonomy under which each net assessment is structured, become a Component Planning Option, or CPO. The selected set of CPOs evolved by each service in Phase II for each budget scenario become the basic building blocks for the defense-wide or global selection process in Phase III.

A crucial decision for Phases II and III is identifying a realistic and appropriate range of future budget scenarios. The remainder of this sub-section discusses this choice.

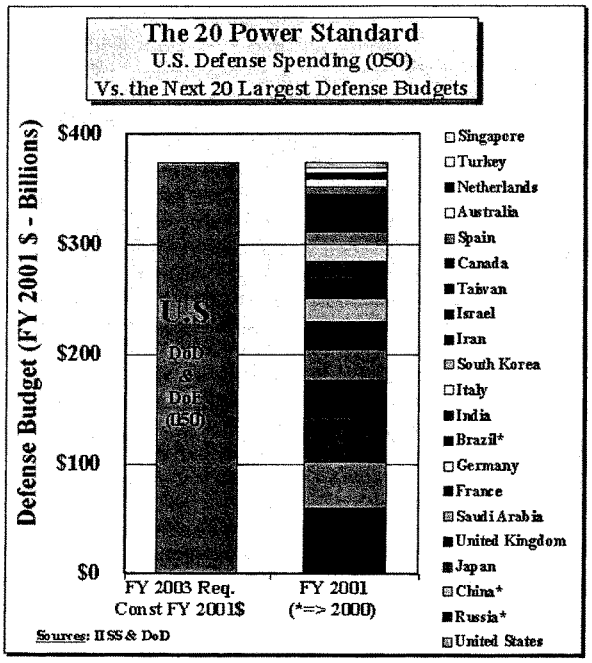
Tighter budget constraints are necessary to discipline the selection process at the microscopic and the macroscopic level of organization. It is therefore absolutely imperative that these budgets scenarios span a realistic range of the future possibilities. The choice, therefore, boils down to a question of how much is enough over the long

term. Like most normative questions, the question of how much we *should* spend is a matter of judgment for which there will never be a clear answer.

While many factors combine to shape this judgment, two general ones stand out and must be explicitly accounted for in any strategic planning process. The first is external. This relates to the threats facing our forces and what our nation wants to do in the world. The second is internal. This relates to the constraints that limit our action. Internal constraints define what is possible over the long term. They require an explicit consideration of internal limitations, like available technology, evolving demographic conditions, and competing non-defense priorities, as well as general economic restrictions.

How Much Spending is Enough? – Accounting for the External Threat

The conventional Second and Third Generation threats posed by competing nation states are enormously diminished compared to the Soviet threat of the Cold War.



Slide 7

Using data in compiled by the International Institute for Strategic Studies (IISS), Slide 7 shows how the U.S. now stands alone in the world, like a colossus, planning to spend as much on defense in FY 2003 as the next 20 largest nations combined.

According to the ISS, the combined defense budgets of the three nations cited most often as threats – the so-called axis of evil made up of Iran, Iraq, and N. Korea -- are less than $12 billion, or only about three per cent of the U.S proposed defense budget for 2003.

To be sure, the spread of non-state Fourth Generation threats, like Al Qaeda, around the globe represent increasingly dangerous threats, but the forces needed to counter these threats do not require the large numbers of high cost, hi-tech weapons or the large standing armies needed to fight the industrial wars characterized by Second and Third Generation Warfare among nations. Nevertheless the overwhelming bulk of the defense budget, together with the current combat force structure and supporting modernization programs, continues to be devoted to conventional and nuclear forces designed to fight Second and Third Generation threats. Only a small portion of the defense budget is allocated to developing, building, and training forces for the irregular requirements of Fourth Generation Warfare, like the war on terrorism.

Clearly, current levels of defense spending are driven more by the legacy of the Cold War and the internal dynamics described in Part 1 than by the external threats we face.

How might we begin to better rationalize this situation in terms of real needs?

Perhaps a couple of examples will help place this question into perspective. The first relates to the Royal Navy and the second relates to Israel. In the late Nineteenth Century, the Royal Navy also bestrode the world's oceans like a colossus when compared to other Navies, but, it should be noted, to a lesser extent than the U.S. military relates to the rest of world's conventional forces today. Strategic planners in the Royal Navy adopted what came to be known as the Two Power Standard to maintain their superiority. They used this standard to plan for the Royal Navy's budgets, particularly its battleship modernization program. The Two Power Standard simply meant that the Royal Navy should maintain a battleship fleet that was at least as powerful as the next two biggest fleets combined, which were those of United States and Germany. Note that this standard was applied to friend as well as foe. If we applied the logic of this standard to the current U.S. defense budget, the next two biggest spenders would be Russia and China (about $102B total). So, a Two Power Standard applied to the United States defense budget would reduce the current budget by over 70 percent.

A second example illustrating the judgment of how much spending is enough is the case of Israel. Israel faces direct strategic threats from Iraq and Syria but also has to consider the potential threats posed by organized military capabilities of Jordan, Egypt, Iran, Libya, and Saudi Arabia in its strategic planning (for the purpose of illustrating this point, we can neglect the additional capabilities of any other Arab Counties, like Kuwait or the UAE, etc.). If Israel applied the Royal Navy's standard to the defense budgets of the above listed adversaries, we could say that Israel maintains a *One-Quarter Power*

Standard. Nevertheless, few doubt Israel's capability to defend itself with its conventional forces in a Second/Third Generation war (like that of 1967 or 1973) against these nations. On the other hand, Intifada I, the debacle in Lebanon, and the ongoing Intifada II, all raise serious questions about the capability of Israel's military to defeat the threats posed by a Fourth Generation adversary. But these Fourth Generation threats, serious as they may be, are hardly related to relative size of the defense budgets of Israel, let alone the United States.

Some might be tempted to argue that a One Quarter Power Standard by Israel is misleading, because Israeli spending is far more efficient than its adversaries. This is true, no doubt. But this argument is a double edged sword, because it would also apply to the Twenty Power Standard of the United States, in effect making the overwhelming nature of that comparison even larger, particularly when applied against the likes of Iraq, Iran, or North Korea.

Our military exists to cope with the real threats to our nation's security. But the bulk of U.S. spending is directed toward maintaining and modernizing its second and third generation military capabilities left over from the Cold War with a modern equivalent of a twenty-power standard.

On the other hand the U.S. is paying the budgetary equivalent of lip service to Fourth Generation threats which are clearly becoming more prevalent and dangerous, as the Aksa Intifada and the war against terrorism show.

Taken together, (1) the low level of defense spending by other nations states suggests that the likely range of possible budget scenarios ought to include lower spending options for the long term as planning scenarios, and (2) the growing importance of Fourth Generation Warfare (4GW) suggests that planners ought to begin allocating more effort to building a force and training people to meet these threats. The 4GW requirement makes it necessary for the services to provide information on how the Component Planning Options produced under the different budget scenarios in Phase II would conform to a taxonomy of second, third, and fourth generation warfare. The notional options described below will provide budget scenarios covering a range of power standards.

How Much is Enough? – Accounting for Internal Constraints

The second factor shaping the selection of a range of relevant budget scenarios relates to what can be realistically afforded and justified over the long term. This factor is internal, and it derives from the long-term pressure to balance the budget while financing the increasing burden of Medicare and Social Security as well as other domestic needs, like education and infrastructure.

There are signs that these constraints may be increasing in the near term, and they are certain to increase sharply over the long term.

The projections of large budget surpluses over the long term are evaporating rapidly. In January 2002, the Congressional Budget Office (CBO) projected that if the tax and spending policies remained the same, the government would run surpluses totaling about $1.6 trillion over the 10 years between 2002 and 2011, a reduction of $4 trillion, or 71 per cent, from the $5.6 trillion surplus over the same period it had projected only a year earlier.[14]

The Congressional Budget Office (CBO) released a report on October, 2000 analyzing the federal government's long term budget outlook. CBO concluded policy changes to Social Security and Medicare (read changes to reduce expenditures per capita) would be needed, because under current policies "... federal deficits are likely to reappear and eventually drive federal debt to unsustainable levels," once the baby boomers start collecting social security and Medicare.[15] If those programs are not changed, CBO concluded in January 2002, decision makers will face the prospect of approving steep tax increases, big cuts in other government spending, or large budget deficits.

Let us now bring the threads of discussion together to identify a range of budget scenarios to guide the conduct of Phases II and III. The absurdity of maintaining a 20 Standard in a world made up mostly of friends, the vastly diminished nature of second and third generation national threats, the rise non-state threats practicing Fourth Generation Warfare, the vanishing surplus, and the looming financial crisis in supporting an aging population all combine to suggest it would be prudent for defense planners to examine the future consequences of alternative courses of action in the context of decreasing defense budgets as well as increasing budgets.

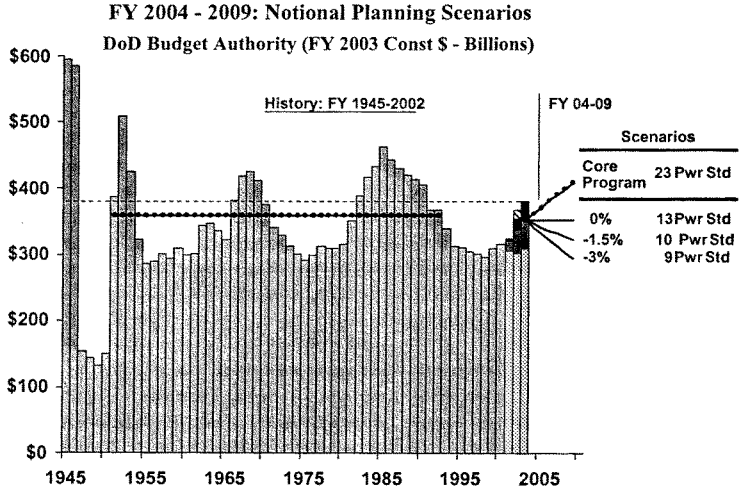
How Much Is Enough? Hypothetical Budget Scenarios

Decision makers, therefore, need to anticipate the possibility that the budget projections in Slide 1 will unravel like those in the mid-1980s (Slide 6).

The only way to break out of the destructive boom and bust cycle is to think through the problem *before* it occurs.

This requires planners to examine the impact of budget uncertainties (and cost uncertainties) before the fact. This can be done through a contingency analysis of the alternative programmatic changes flowing from a range of pessimistic budget scenarios as well as those attending the optimistic scenarios. Once the effects of these changes are understood, planners can synthesize the mix of force options best able to cope with or adjust to the effects of the uncertainty. In so doing, planners can discover a priority system that identifies what is truly important and what is nice to have. Under this approach, priorities are not set arbitrarily before the fact but are viewed as emergent properties discovered via an iterative trial-and-error process of combination and selection.

Bearing in mind that the war on terrorism will be funded on a pay-as-you-go basis, Slide 8 introduces a range of three alternative spending scenarios to the core Defense program that was put into place in August 2001 (see discussion Slide 1). These four notional scenarios are examples of the kind of constraints that could be used to guide the trade offs in Phases II and III. During the service-controlled deliberations of Phase II, the budget share allocated to each military service and defense agency would be determined by the average proportion of the total budget it received during the first decade of the post-Cold War era (1991-2000). These shares equate to 26% for the Army, 31% for the Navy and Marine Corps, and 30% for the Air Force, with the remainder being allocated to the various defense agencies.



Slide 8

Slide 8 should be read as follows. Using the more reliable pricing information produced by the book cleaning operation of Phase I, planners in each service would assemble and price out four budget scenarios based on the overall constraints portrayed in Slide 8. These options include –

1. The Core Program, which would an extend the program put into place in August 2001 (see Slide 1) for two year and build to a 23 Power Standard by 2009, assuming other countries maintain a budget freeze. Under this this option, the defense budget in 2009 would be 14% higher than that averaged during the 40 years of Cold War.

2. The second scenario (0% real growth per year) would freeze the budget in constant dollars at 98% of the cold-war average, resulting in a 13 Power Standard in 2009.
3. The third scenario would would decrease the core program by 1.5% per year, declining to a 10 Power Standard by 2009 or 90% of the cold-war average.
4. The fourth scenario would decrease the core program by 3% per year, dropping to a 9 Power Standard by 2009, or 82% of the budget averaged during the Cold War.

Phase III - The Construction of Strategic Planning Options

Phase III operates according to the following principle: What is best for the individual military service may not be best for the Defense Department or the nation.

The aim of Phase III is to synthesize the parochial priorities of Component Planning Options (CPOs) produced by each service in Phase II into a coherent system of *national* defense priorities that reflects and exploits the changed conditions of the post-Cold War era. This task should be the responsibility of the Joint Chiefs of Staff (JCS) and the Office of the Secretary of Defense (OSD). In Phase III, JCS and OSD would combine the CPOs produced by the military services in Phase II into a comprehensive set of DoD-level Strategic Planning Options (SPOs) covering the four budget scenarios portrayed above.

The force options in the 12 CPOs (4 from each service) produced in Phase II, plus those of the defense agencies, including their net assessments, provide the building blocks of a true policy-level decision-making process. Like their service counterparts in Phase II, planners in JCS and OSD would use a *combination-and-selection* process to continuously maximize the strengths and minimize the weaknesses of the total force while conforming to the macroscopic budget constraints of each scenario. In this way, they would systematically explore the marginal effects of different macroscopic combinations. Creative tradeoffs among the variety of individual force packages might reveal interesting new macroscopic possibilities. The most effective Option #2 DoD SPO, for example, might combine a Option #4 Air Force package with a Option #1 Navy/Marine Corps package and a Option #3 Army package.

Perhaps a hypothetical example of this JCS/OSD SPO will make the idea more concrete: Option #2 would freeze the DoD budget at its current level out to FY 2009, resulting in a 13 Power Standard in FY 2009, implying a reduction of $57 billion from the level projected for FY 2009 by the Core Program. Under the tighter restrictions of this constraint, strategic planners might choose to spend far less on the Air Force (an Option #4 CPO). They might do this by transferring a very large percentage of its forces to the reserves, which are noted for their excellence, and closing a large number of bases, thus preserving its combat power for a mobilization/reinforcement scenario. They might also choose to reduce the Army's budget to an Option #3 CPO by eliminating some active forces and transforming its active/reserve divisional structure into a much smaller and leaner force structure based on heavy, light, and medium weight battlegroups, made more flexible in expeditionary 4GW scenarios by a de-centralized command and control

system. Such a force would be more deployable in the short term, but would preserve the balance of a large continental army, should we need to expand it sometime in the distant future. These reductions could permit planners to fund the more expensive, re-priced Navy/Marine Option #1 CPO while conforming to the tighter constraints of the Option #2 budget projection.

Senior planners might argue that this hypothetical Option #2 SPO better adapts the military to the realities of the post-Cold War era. It returns the United States to its traditional military posture, based on intervention, as opposed to forward basing of large forces, because it:

- Reduces the budget;
- Maintains the expeditionary capabilities needed to protect our historical interests in the world's littorals, with the Navy and Marine Corps being the rapid deployment option, reinforced by the more mobile Army battlegroups and mobilized Air Force reserves, if necessary.
- Retains a capability to field the heavy air/ground combat power needed to offset any major power imbalances in Europe or East Asia, should the need re-emerge sometime in the distant future. The supporting modernization programs, nuclear forces, and programs in the independent defense agencies would also be tailored to fit the world conditions that are implied by this strategic choice.

The information produced in Phase II would permit the exploration of such tradeoffs by JCS and OSD planners as they search for and evolve truly national priorities out of the parochial priorities of each service. JCS and OSD would conclude their efforts by producing a macroscopic net assessment for each preferred DoD SPO. This net assessment would include the assumptions and tradeoffs made, an analysis of its deficiencies and limitations, its impact on national security in terms of achieving goals and neutralizing threats (categorized by the taxonomy described earlier), and the best military strategy for working around its limitations. The final report, when approved by the President, would be a comprehensive strategy coupled to the skeleton of a new FYDP, complete with global priorities and pre-planned hedging options to cope with uncertainty.

The systematic combination and selection process at the different levels of organization would provide the ingredients of a seamless information system that permits decision-makers to shift their focus back and forth among the microscopic and macroscopic levels of organization. This kind of decision-making information would reveal the true cost of a *microscopic* decision by forcing an examination of its *macroscopic* consequences *prior* to making commitments. If, for example, AF planners insisted on buying more B-2s in each CPO or SPO, they would have to eliminate more and more other programs -- such as F-22 fighters, carrier battlegroups or army divisions -- as they moved toward lower budget levels. These tradeoffs, coupled with excursions into the consequences of cost growth,

would reveal when the cost of the B-2 becomes prohibitive in terms of the incommensurable sacrifices made elsewhere. In this way, the reciprocal explorations of these microscopic and macroscopic uncertainties would enable planners to anticipate problems, tease out options, evolve priorities, and perhaps do things differently.

Faultfinders will be tempted to argue that the Phase I program freeze will create chaos in the middle of a war. This criticism is patently absurd for three reasons: First, it formally acknowledges the fact that the war is being funded on a pay-as-you-go basis, and by doing so, will make the costs of this war more transparent to the American people. Second, the defense program is already in chaos and the recently completed QDR and PPBS cycles did nothing to diminish it. Third, and most important, the Defense Department's bookkeeping mess makes a mockery of the principle of accountability and, by extension, the Constitution we have sworn to defend. Fixing the books eliminates a threat to constitutional governance by making our decisions transparent and understandable to the Congress and the American people. Moreover, it is a moral duty, given our oath to preserve and protect the Constitution.

Others may argue that threats should drive strategy, but this proposal has budgets driving strategy. This linear babble ignores the nonlinear nature of strategy, not to mention the changed conditions of the post-Cold War era. In the real world, actions to neutralize threats and the constraints limiting those actions continuously interact with and fold back on each other. This proposal enables planners to shape a real strategy precisely because it is designed to explore the co-evolving interplay of threats, events, opportunities, internal structures and constraints.

It might be feared that even thinking about lower defense budgets will create a self-fulfilling prophecy, because it will open the door to opportunistic budget-cutting by an irresponsible OSD or Congress. This argument plays well in the mendacious atmosphere of Washington. But it must be rejected for logical as well as moral reasons: To say that the Pentagon should continue producing irresponsible plans, because acting responsibly will provoke OSD or Congress into acting irresponsibly leads to the conclusion that we should deliberately misrepresent our needs; in other words, we are justified in committing a crime—lying to Congress—because we are morally superior.

Strategy is not a game; it is the art of the possible in a world where changing threats and constraints force us to choose between unpleasant or imperfect alternatives. The aim of any strategy should be to continuously improve our capacity to shape and adapt to these changes. To do this, we must continually strive to improve the "fit" of our plans to the reality we face today while preserving or increasing our fitness to cope with unpredictable changes in the future. If we want meaningful strategic priorities, we must understand the tradeoffs they imply *before* we make rigid commitments that lock us into a long-term, non-adaptive course of action. Who knows, with a little accountability, perhaps the Pentagon can learn to think before it spends. That might help the President and Congress adapt our military forces to the end of the Cold War, balance the budget, avoid a budget war with Social Security and Medicare, and preserve the integrity of the Constitution.

[1] Interview with Representative Curt Weldon (R-PA), the chairman of the procurement subcommittee of the House Armed Services Committee, Aerospace Daily, March 15, 2002.

[2] Tony Capaccio , "Lockheed, Boeing, Northrop Programs Are Eyed For Cuts," Bloomberg.com, May 29, 2002.

[3] James Dao "Rumsfeld Resisting Calls From Military To Build Up Forces," New York Times, April 19, 2002.

[4] Transforming Department of Defense Financial Management A Strategy for Change, April 13, 2001, Executive Summary, page i.

[5] General Accounting Office (GAO/NSIAD-96-152R), April 30, 1996, a report sent to Senators Grassley and Roth.

[6] A more detailed explanation of the Defense Power Games can be found at the following url: http://www.d-n-i.net/FCS_Folder/power_games.htm

[7] The effects of inflation cannot be avoided because the early plans in FYDP database did not account for the future effects of inflation, and attempt to remove the effects of inflation would require arbitrary and debatable assumptions. Besides, the question under discussion is the comparison of plans to reality as opposed to the absolute level of the budget. As long as both items in the comparison are made on the same basis, it makes little difference whether or not inflation is included.

[8] The entire SAR data base is available on the internet at http://www.acq.osd.mil/ara/am/sar/

[9] Examples of failed strategic reviews include "PRM-10" during the Carter Administration, the "National Strategy Review" and "Base Force" during the Bush Administration, and the "Bottom-Up Review" at the beginning of the Clinton Administration. The fact that special reviews are deemed necessary ought to raise a question, because the Defense Department's Planning, Programming, and Budgeting System (PPBS) is structured exactly like this logic chain and has been the central strategic planning methodology since the early 1960s. If this logic worked in the real world, periodic strategic reviews would not be necessary.

[10] Students of cybernetics and complextity theory will recognize the characteristics of a complex adaptive process are central to this view of strategy. This implies the phenomenon of self organization and unpredictability.

[11] How to comensurate the incommensurable is the key problem we face. If everything could be reduced to interchangeable measures of performance, choices between options would be easy. But the real world is not like that. Viewed epistemologically, the problem is one of making tradeoffs between alternatives that do not have common denominators that can be measured directly. If one is choosing between two heavy divisions and a B-2 bomber, there is no common element to guide the choice other than money, which measures input, not output. The best (or least bad) choice depends on

subtle indirect effects. The only decision making process we know in nature that makes these kinds of choices effectively is natural selection. The process outline in this subsection can be thought of as a kind of artificial natural selection process driven by a pre-definition of selection pressures that might occur. The best discussion of the philosophical nature of this problem, I believe, is the classic 1968 paper written by Garret Hardin "The Tragedy of the Commons," (Science, 162(1968):1243-1248,) which can be found on the web at http://dieoff.org/page95.htm

[12] James P. Stevenson, The $5 Billion Misunderstanding: the Collapse of the Navy's A-12 Stealth Bomber Program.

[13] See http://www.belisarius.com/modern_business_strategy/vandergriff/sbt_intro.htm A compendium of writings on this categorization can be found on the at http://www.d-n-i.net/FCS_Folder/fourth_generation_warfare.htm

[14] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2003-2012," January 2002 available at http://www.CBO.gov/showdoc.cfm?index=3277&sequence=0&from=7

[15] Congressional Budget Office, The Long Term Budget Outlook, October 2000, available at http://www.cbo.gov/showdoc.cfm?index=2517&sequence=0&from=7

Mr. SHAYS. Thank you all very much, and we'll start with Mr. Kucinich.

Mr. KUCINICH. I want to thank the panel, and I want to thank in particular Mr. Spinney for his very thorough and incisive testimony that you had laid out in its presentation to this committee in its totality.

Mr. Spinney, there was one point in your written testimony I think that was particularly important. You point out that, because of misestimations of the unit cost of weaponry by the Pentagon planners, production rates end up being lower than anticipated. This in turn leads to a lower replacement rate, which, if I understand correctly, means that not enough equipment is purchased in a timely manner to replace all the older equipment targeted for retirement. The result of all this is an increase in the average age of equipment, meaning that the equipment costs more to operate ultimately. Then you're left with a shrinking force structure.

Have I described this sequence correctly?

Mr. SPINNEY. Yes, sir.

I would add one thing to that. One reason why the production slips is, as the costs of the weapons go up, they get progressively more complex. So we have a complexity induced factor in the cost growth as well, and over time what we have is an aging force that's getting more complex at the same time. So the interaction between growing complexity and growing age has a multiplier effect and drives up the costs much faster than either one would alone.

I have a lot of data to back that up, by the way.

Mr. KUCINICH. Why does it drive up that cost?

Mr. SPINNEY. Well, more complex pieces of equipment are obviously more expensive to operate, but they also age in a less gracious way, so to speak. Their costs grow faster than simple planes.

I have data, for example, showing an A–10, which is a relatively simple, plane and if you compare that with an F–18, which is a relatively complex plane, and if you look at the cost growth over time as a function of age, you will see that the F–18 grows at a much more rapid rate than the A–10. That's a perfectly reasonable expectation.

The key point here is as our equipment gets more and more expensive over time, even though we are not replacing it at the sustainable rate, the force is getting more complex.

Mr. KUCINICH. So you have less planes in this example.

Mr. SPINNEY. Absolutely. We have a shrinking force, a more complex force and an older force; and the operating budgets go through the roof.

Mr. KUCINICH. Where does this end up, where we have one plane?

Mr. SPINNEY. That's what Norm Augustine used to like to say tongue in cheek. Basically, I call it the death spiral. Our forces go down over time. And this has been going on since 1957 or so. There have been blips in between.

A key point to understand here that I should have made in my chart showing the budget is that budget that's growing in the future is supporting a force today that is between 50 and 60 percent as large as it was in the 1980's and it's probably 25 percent of what it was in the 1970's and the 1960's.

Mr. KUCINICH. So the American people are paying more and getting less defense, is that what you're saying?

Mr. SPINNEY. Yes, sir. It's a much more complicated thing.

Mr. KUCINICH. Now in your testimony you demonstrate that a major factor in all of this is the planners' gaming strategy, you call it front loading, where the planners and the contractors lowball their estimates of how much a weapon will cost in the outyears of production. Your contention is that, once these outyears are reached and the true costs of production become evident, there's no longer the political will to cancel the program and so production rates are stretched out. Is that a right interpretation of what you're saying?

Mr. SPINNEY. That's correct, and that is because the political engineering process that follows the front-loading process and the political engineering process basically is aimed at spreading the production base around the country to build as much constituent pressure to support the program as possible.

Mr. KUCINICH. What we're talking about, you know, rather than upgrading equipment, what we're buying with our defense dollars is an older, smaller force that's more expensive to maintain?

Mr. SPINNEY. Yes, sir. And our plans will actually show you that age will continue increasing in the future. Secretary Rumsfeld acknowledged this fact obliquely in his testimony before the Senate Armed Services Committee this year.

Mr. KUCINICH. So we're talking about a readiness crisis that Pentagon officials keep pointing to and keep citing as a justification for increased defense spending.

Mr. SPINNEY. Yes, sir. I would say it is of our own making. The problems start at the Pentagon. We get a lot of help from Congress. But it's not—a lot of this happens because people are coming through the system so rapidly and getting at the point that the other Congressman was making, Congress Tierney, that we don't have the kind of corporate memory. So a lot of people come in and they go along with this stuff in the short term and they don't really get the big picture until they leave.

Mr. KUCINICH. I am listening to your explication here and what it suggests to me is, despite what the administration claims—or any administration for that matter—in this case they have an extra 45 to $50 billion Congress is going to be providing to the Department of Defense next year to provide that money. But based on what you say there's no—what's the possibility of American people getting extra security out of this? What does this do?

Mr. SPINNEY. There's no way you can answer the question.

Mr. KUCINICH. So you can't answer it.

Mr. SPINNEY. Nobody can.

Mr. KUCINICH. You can't back it up when you say you're going to have more security.

Mr. SPINNEY. No, sir. Well, I think a better way to say it is, if you look at the details of that plan, can you have a reasonable expectation that the building blocks of that plan—which, by the way, are output oriented in the PPBS, at least in theory—there is absolutely no guarantee that those things will, in fact, unfold over time.

Mr. KUCINICH. How will fixing the Pentagon's books overcome this—change the outcome?

Mr. SPINNEY. Fixing the books is a necessary condition. It isn't a sufficient condition. And that's really the way I view this problem, which is very different; and I'm coming from a different perspective than the earlier witnesses, particularly on the first panel.

The way I view this problem is that we have to provide better information; and, in this case, the best is the enemy of the good. We can take action today to really improve our information in the short term if we did a crash program, in my opinion. That wouldn't fix all the accounting problems that were discussed earlier. But the key thing is to put together a budget that more realistically reflects the future consequences of today's decision, which is the decision to appropriate that budget. We can do that I think probably in 12 to 18 months if we put our minds to it.

The real thing we have to do is we have to set up a decision-making process that basically forces these uncertainties out on the table so the decisionmakers, when they're trying to decide and evolve what their priorities are, can basically make a selection based on these uncertainties.

I am not explaining this very well. I tried to lay that out in the second half of my testimony, but the crucial thing here is to provide enough reliable insight into the consequences of a decision so you can account for them before the fact; and I submit that the way to do that is through some sort of contingency planning.

Mr. KUCINICH. In the few minutes I have remaining in this round I just want to go through some questions that occurred as a result of reading your testimony. You have mentioned defense power games and front loading and political engineering. Looking at that, do you really mean to suggest that defense planners and contractors misrepresent the costs of your weapons programs and seek to spread subcontracts around the Nation to ensure the survival of those weapons programs?

Mr. SPINNEY. Oh, I think it is very deliberate. Yes, sir. I have talked to many contractors about this; and, of course, they won't come up and testify that they do that, but they have told me they do it.

Mr. KUCINICH. And that means Congress is part of it.

Mr. SPINNEY. Yes, sir. Congress is going along with it.

I had a conversation with one corporate vice president. He was an executive vice president of a major aerospace company, and I took him through the whole front loading argument. It was part of a 5-hour lecture that I had that we give to the entire staff, the company.

Basically, his bottom line is, he says, look, we have to do this. Because if we come clean, we won't get the contract because everybody else is doing it; and that's the dilemma. And the same thing exists inside the Pentagon. Because there's a constant competition for resources, you have different factions fighting with each other to try to do what they think is best.

I am not talking about malevolent behavior here, but they naturally try to win the competition, so they tend to be overly optimistic. And the basic argument that you make when you do that is, if I don't do this, I'm going to lose the battle.

When I was in the Air Force on the air staff in the early 1970's as an internal Air Force thing to force the senior officials to try to

consider what lower budgets would do, how they would come up with a list of the kind of programs they want to cut, you couldn't get them to do it.

Mr. KUCINICH. You know, this testimony and this hearing kind of reflects on President Eisenhower's warning about the dangers of the military industrial complexes. Because what's happened here is that this just isn't about an administration. This is about the Congress. This is about a system which has now run amuck, and we're starting to see how it can have a material effect on the eroding of the quality of our democracy because we don't have sufficient funds to take care of health care in America. We don't have sufficient funds for education. We don't have sufficient funds for housing. We're told that we're challenged with our retirement funds. So when you look at all of those issues which relate to a democratic society and its maintenance and support, this problem that you're describing, Mr. Spinney, has profound implications for this country.

Thank you.

Mr. SHAYS. Thank you.

Mr. Tierney.

Mr. TIERNEY. Thank you, and I thank all of you for your testimony.

Let me just ask, Mr. Kutz, sir, the policy that was just discussed of trying to spread around the contractors' work throughout the country on the notion that it would build political support for a particular weapons system or program, have your reviews evidenced any sign of that, that it was decisions made on anything other than a contractual basis or sound business judgment?

Mr. KUTZ. That's a little outside my area of expertise, but certainly as one of our high-risk areas in acquisition management we have seen some of the things that Mr. Spinney talked about from the standpoint of effect and results at the end of the day. I'm not sure we have gotten to the bottom line of some of the causes of some of those things, but certainly our high-risk talks about more program than budget and certainly a history of programs coming in with lower estimates than reality and you get less weapons at the end of the day—and we have our expert here on acquisition, if you want more from a GAO perspective.

Mr. TIERNEY. I guess either he or you can talk a little about how the contracts are spread out around the country and whether there's a pattern that develops or whether it just seems that every competition for a contract ends up that way, that somebody in each part of the country makes that some part of the system.

Mr. KUTZ. Certainly, factually, a lot of the major weapons systems have contractors, whether they be major contractors or subcontractors, all over the country. That is certainly factual from what we've seen.

Mr. TIERNEY. Generally you try to have your supply sources closer to your manufacturing sources or whatever, and that seems to cut across the grain. It would be, as a business guess on my part, at least, that it's not sound business judgment that's driving that but something along the line of political support. But you never did an analysis of that or anything?

Mr. KUTZ. Our other witness wasn't sworn in, and I don't know if you want to have him sworn in to have him comment on that.

Mr. SHAYS. I'd be happy to do that. Anyone else you may be asking?

[Witness sworn.]

Mr. TIERNEY. Please identify yourself, also, as you speak.

Mr. FRANCIS. Good morning. My name is Paul Francis, and my main area of expertise is in the acquisition area.

I think, Mr. Tierney, in response to your question, we don't look at that specifically when we're looking at a weapons system, but we have on occasion in the past in response to requests looked at individual weapons and where the contracts are spread; and I'd say our information tracks pretty well with Mr. Spinney's that the subcontracts get spread over quite a number of States.

Mr. TIERNEY. Have you ever analyzed that from the perspective of whether that raises the cost of the overall weapons system or not? Seems to me that, by spreading them out that way, transportation, delivery, other costs all seem to go up. Must have an impact on the overall cost of the program.

Mr. FRANCIS. I think that's probably true that the cost of transportation will go up.

I think, arguing on the other side, is the prime contractor would say they want to go to the supplier that has the most expertise. So, in the long run, there's probably a tradeoff there.

Mr. TIERNEY. Thank you.

Mr. SPINNEY. May I make a comment on that?

I did an in-depth study of the C–130, which is a very simple airplane built in a huge factory in Georgia; and they contracted out aft fuselage sections. Now all this was stringers and sheet metal that could easily have been made in the factory, and they had them produced in various factories in different locations and then would bring them together and assemble there. There was all this extra space. The quality of the work was exactly the same.

I was in the factory, and I saw them sort of messing around with their production line, twisting them around. I asked the blue collar worker—I said, why are you doing this? This is a dumb way to run a production line.

He said, well, it just came in from the shipping dock; and we have to move it around to do it.

I said, you mean to tell me that they shipped this in here?

He said, yes, sir.

So I said, it's cheaper to build aft fuselage sections in State X and then ship them to the State of Georgia and assemble them.

He said, no, no way at all. We did this for political reasons. It's understood on the production line.

That's my point. And I might add that the cost of the C–130 H—it went into production in 1969, if my memory recalls correctly—in today's dollars, taking out the effects of inflation, I believe its cost was about $11 million a copy. By 1993, when we produced our last C–130 H, virtually identical to the first one in today's dollars, taking out the effects of inflation, we are paying $41, $42 million for a C–130.

Mr. TIERNEY. Is there something—a study—along the line of trying to determine whether or not it makes good business judgment versus good political judgment to spread these contracts around? Is

there something in the purview or abilities of GAO to do a report on?

Mr. FRANCIS. I think that would be kind of a touchy subject, especially on the political side.

I think we could probably take a look at whether it makes business sense and what the business case is for doing that. I don't think we would take on the political side.

Mr. TIERNEY. Maybe perhaps something on the idea of what percentage of contracts do get their work spread out over multiple States and then what the business case is for that versus what a sound business case is or not.

Mr. FRANCIS. Certainly, I believe we can get the data on that.

Mr. TIERNEY. If I could just ask anybody on the panel, maybe starting from my left all the way over, who wants to respond to this, earlier, we talked about incentives. What can Congress do to provide an incentive? Which is kind enough of you to say that having regular hearings or meetings would be one incentive, but beyond regular committee meetings of oversight, what financial incentive might we have that would hit the pocketbook of the Department of Defense where it would not hurt our defense posture or abilities but would stimulate action on getting better acquisition programs as well as better financial accountability in reform of that program?

Mr. Schmitz, I'll exempt you if you are too recent on the scene to have an opinion on that, but, Mr. Lieberman.

Mr. LIEBERMAN. Well, I think, sir, that the Congress should insist on very explicit milestones. Gets back to this idea of what is the road map and does everybody understand whether progress is being made or not. And the release of money can be tied to these milestones. That's the way the Department runs its investment projects.

There's no reason why the authorizing and appropriating committees, for example, cannot expect the Department on a periodic basis, certainly annually with the President's budget, to lay out exactly whether progress has been made or not. And then you have the power of the purse—you can make the decision of whether you want to keep funding those projects that are slipping.

Right now, the problem has been this myriad—the chart is gone, but the myriad of systems, many of which have money being spent on them right now to modernize them or change them or replace them. There's inadequate visibility to the Congress in terms of which of these are making progress and which aren't; and even though some of these projects are reviewed in-depth by various congressional committees, it's not in the context of this overall financial management improvement plan.

So my suggestion would be hold the Department's feet to the fire in terms of revealing to the Congress exactly what this blueprint is that they're now formulating. And over time there has to be sustained interest. If interest drops off after 1 or 2 years, the probability of the Department's interest dropping off is astronomically decreased.

Mr. TIERNEY. Thank you.

Mr. KUTZ. I would say two things. The oversight is definitely one. Consistent congressional oversight such as this gets the Depart-

ment's attention, but the other thing that gets their attention is money. And certainly with respect to the $26 billion we talked about, a large chunk of that—and I don't think anyone knows exactly which piece of that goes to the business systems.

Mr. SHAYS. I just want to verify that 26 was all information systems. So that's in all the weapons systems. So that number of $4 billion was probably closer to being the accurate number.

Mr. KUTZ. There's a document that supports the $26 billion that's about six inches deep that we haven't quite gotten into the details of it, but it is a large portion of the 26. I don't know what, though, is related to business systems.

But what happened—and, again, I think what Mr. Lieberman says is right on target with respect to they are spending money as we speak on systems that are going to perpetuate that stovepipe environment that you saw there and they do not have control yet of all the projects going around. There are buckets of money all over the Department that are being spent on IT improvements or upgrades that are not being controlled properly at this point, and that is one of the reasons to get the architecture in place and to put those controls in place.

Now we are talking about external incentives, obviously, internal incentives. But one of the things Mr. Hite can elaborate on that the Internal Revenue Service had, the Appropriations Committee I think got quite frustrated with some of the disasters they had back in the early to mid 1990's with tax system modernization; and they actually developed an investment technology account that all the money went into that had significant scrutiny before it was spent on systems modernization. Now with DOD whether that will be practical or not I don't know. But certainly at IRS it provided more visibility. With that money, you could see actually what was being spent on maintaining systems at IRS versus developing new systems at IRS. So that is one idea to consider.

Mr. TIERNEY. Let me make sure I am getting this right. So what we might do is take the IT money and set it in an account and then say that, before any of it is spent in this next fiscal year, some appropriate person or entity would have to make a determination that money was being spent either in moving toward the reformed final product or obtaining something that is necessary to that end.

Mr. KUTZ. Incremental business cases would have to be developed to support the spending of that money with oversight from Treasury and OMB, GAO and the Congress.

Mr. Hite can maybe elaborate a little bit on that, too, because he's involved with IRS.

Mr. HITE. The scenario that's in place not only at IRS but also in place in Customs and there is legislation being proposed to put in place at INS with regard to their entry-exit system recognizes that trying to build large, monolithic systems over many years is very complex and difficult to predict and you end up waiting years and years and years before you realize you didn't get what you expected. It cost a lot more, and we're not near where we need to be.

So what you do is you take that large, monolithic goal and you break it into incremental pieces. Then, through the legislation, the agencies are required to put together expenditure plans that says incrementally what they intend to do and what they intend to get

for their money. They have to submit this to the Congress through the Department, in the case of IRS through the Department of Treasury, and OMB and reviewed by GAO; and we offer advice and counsel to the Congress in its decision on the release of the funds that have been appropriated.

It's through these incremental expenditure plans that you measure and you have awareness as to whether or not you are progressing toward the desired end and don't have to wait many years to realize that you're not making the progress that you desire.

Mr. TIERNEY. Doesn't that also address the fact of money being spent on systems that are going nowhere toward that other plan? That is sort of like money being spent to maintain a system, but it has nothing to do with the other plans, and nobody reports it as being moving toward that goal or not.

Mr. HITE. Well, absolutely, because the conditions that have been written into law—and we work with the committees in doing this—make explicit, for example, that the expenditures have to be in alignment with the enterprise architecture. Because if they're not, then you don't have a justifiable basis for what you're doing.

Mr. TIERNEY. Thank you.

Mr. Spinney? We were doing a left to right, as to what might be a good way to incentivize some positive action in terms of this financial accountability reform or, in the case of things you testified to, stimulate action without hurting our defense in terms of having a good procurement system and a good expenditure system.

Mr. SPINNEY. I am not a financial manager. I have to answer your question from the perspective of a program planner; and, basically, I think you have to hit the system over the head with a club. The—it's going to take a long time to fix these financial systems under anybody's estimate with the best of intentions. At the same time, we have to provide the Congress with a budget each year; and we are talking big, big money; and we are making decisions that have implications reaching far, far into the future. A decision to buy a new aircraft carrier is basically a commitment for spending money over 40 to 50 years, maybe longer.

So what we need to do is we need to do something in the near term to provide better management level information that can be used in the PPBS to support the Secretary when he's putting together a program plan. These plans that we're producing now are just not connected to the real world, and we have to figure out a way of connecting them.

My view is the best way to do that is to force the OSD and service bureaucracy in the Pentagon to put together some contingency plans at lower budget levels so we can smoke out the costs of the real programs. The data won't be the best in the world. But if we basically made it a top-priority effort, we could assemble the information.

I have seen how the bureaucracy can work; and if you crack the whip, it can happen.

Mr. SHAYS. Mr. Spinney, you have a perspective, being inside. Unfortunately, when you told your anecdote you lost some credibility with me, because you and I know that if you went into any plant and asked any blue collar worker at that plant whether it would be more efficient to make it in this plant or make it some-

where else he would say it's more efficient to make it in this plant. So, you know, it is—that person has no sense of the cost of the product.

Mr. SPINNEY. That was confirmed by management.

Mr. SHAYS. I am just going to say to you, Mr. Spinney, when you told that story, that's not relevant. If you have another story to tell, then that is relevant.

The problem you're dealing with—right now, we are looking at two issues. One is, you're looking at a political issue of whether Congress, the White House, the administration choose to disguise the cost of programs by taking a 5-year budget and spreading it out over 8 years and keep pushing off the product; and we all know that's happening. We make every product and every program more expensive because we don't face up to its true costs in the period of time we're going to budget it. We then stretch it out, and then we make it more expensive to build, and each year they have to readjust their—the producer has to remanufacture, reproduce his budget or their budget to reflect different costs.

But that's a political thing. We do it—right up here we do it, and it's wrong.

But that's one issue. The other issue is the issue of whether we have a system in place, irrespective of politics and political decisions, that will tell us honest information; and the primary interest that I have in this hearing is do we—even if we want to be straightforward about it, do we have a system in place? And we don't.

I want to ask you, Mr. Lieberman, what are the underlying causes for the failure of the previous management decisions? I mean, I interrupted you, which is not my general practice in the middle of a statement, but I mean I have been at other hearings where you've testified and others have testified and we're told what they're going to do. So what's different about this one as opposed to all the other hearings in terms of what the administration says?

Mr. LIEBERMAN. Well, I think there are a number of differences.

First of all, this Secretary of Defense is the first Secretary that I can remember—and I can remember quite a few of them—who actually has come out repeatedly saying that the financial management system is badly broken, needs to be fixed, and he expects it to be fixed, and he is willing to spend money to fix it. Even though a lot of money has been spent in the past, there has been denial about how much this is costing. To this day, nobody can tell you exactly how much money is being spent to improve financial systems. This is one of our criticisms of DOD's plans over the last several years.

Mr. SHAYS. Let me ask you then, so that when the $26 billion, which is the first number we were using and then brought down to $4 billion, you think it's somewhere in between that $4 to $26 billion?

Mr. LIEBERMAN. Some fraction of that. It's probably some part of the $4 billion is being spent specifically to upgrade systems so that they will do a better job in terms of complying with accounting standards, for example.

DOD, because of congressional requirements, finally started about 4 years ago providing a plan, a financial management im-

provement plan, to the Congress which was voluminous. It was this thick. But nowhere in there could you find a flat statement about how much it was going to cost to achieve CFO act compliance, nor could you find how much was in the budget in any given year and whether there was any difference in terms of are they fully funding this improvement plan or not.

Still, to this day, the Department can't tell you how much this is going to cost, because we're now at the point of stepping back and creating an entirely new blueprint. Once the blueprint is created, it has to be costed out in terms of how much money is going to be necessary.

But I digress slightly. Secretary Rumsfeld was willing to put up almost $100 million in the 2003 budget and Congress appropriated that amount to do this enterprise architecture exercise; and that's the first time any large, visible chunk of money has gone into a DOD budget for financial management improvement ever. So we are at least facing reality.

Mr. SHAYS. I am just concerned that when you leave the Inspector General's office are you looking to get a job with Rumsfeld?

Mr. LIEBERMAN. Well, thank you very much.

I do think that Dr. Zakheim certainly has very clear marching orders that, unlike previous comptrollers, he's not supposed to just be worrying about the budget. He's supposed to be worried about this financial management improvement effort. He's doing things that sound mundane, but they are the things that were not done in the past. That is, there will be an explicit, detailed plan. At least we're spending an awful lot of money to have such a plan created; and, hopefully, we're going to get our money's worth. There will be explicit performance measures. There will be the kind of milestones I was referring to earlier. They will be able to show you a chart that says, this is where we're trying to get to. Matter of fact, they ought to be able to show you a series of charts showing you every 6 months where they're supposed to be in order to get to that end state.

Mr. SHAYS. Which strikes me as really what we should do. Depending on what Mr. Horn does and his committee, we should just schedule a meeting every 4 months or hearing every 4 months where they come in and give us an update. That would probably be the biggest incentive.

Other comment? I interrupted you. Are you all done?

Mr. LIEBERMAN. I would sum up just by saying there is now a management structure to run this whole thing like a program with someone in charge with a clear idea of exactly what needs to be done, much better chance of accountability being possible. If the milestones are not being met 6 months from now, a year from now, 2 years from now, you can terminate contracts. You can replace DOD officials. You can have the wherewithal to grab hold of the situation and control it. And all of that, I think, is new.

Then, finally, the departments—the military departments seem to be more on board than they were 2 years ago. They must be kept on board. They must not be allowed to not play in the game.

Mr. SHAYS. Do you believe that the comptroller has all the authority necessary to accomplish these reforms?

Mr. LIEBERMAN. He's going to need reinforcement from the Secretary of Defense from time to time. He can have all the authority in the world on paper and there will be times there will be centrifugal forces here and you will have very important people in the military departments resisting his priorities. So he's going to need to be able to go down the E-Ring to the Secretary and get continued very strong support.

He's also going to need help from the chief financial officer, who we have not mentioned throughout this hearing, even though we are talking about what's fundamentally a systems problem. If you look at the charter of the CIO on—based on the Chief Informations Officers Act—you would say, well, gee, there's somebody who is the czar of information systems and that person should be controlling this whole project.

We have overlapping charters for these officials, and that's not necessarily bad because it means that they ought to be able to join forces and get things done. But I think the CIO community must play big time in this whole effort.

Mr. SHAYS. The kind of issue Mr. Spinney was raising with regards to not properly accounting for the cost of a weapons system, which is legion in this government and has been for a number of years, at least for the last 20, is whatever we do with an accounting system and our financial management won't necessarily change that fact, will it?

Mr. LIEBERMAN. Well, there are things that can be done that will help. We issued a report earlier this year talking about the lack of a standard cost accounting system to track costs throughout the life-cycle of weapons systems. The department has a variety of systems attempting to do that right now. I'm not sure if some of them are probably some of the icons on that chart. But we do not have one that is standard that top management can rely on.

So one of the ways you get smarter about estimating future costs is to understand current and past costs better, and that's one of those many IT improvements that still needs to be done. Hopefully, there's some money in that $26 billion to move forward with that particular system.

But I would commend that particular IG audit report to the committee's attention. It showed a circumstance in which the Department had declared victory without having won the battle in terms of that system.

Mr. SHAYS. What I would like to do is have Mr. Schrock take the Chair.

Mr. Lieberman, I hope this committee will be invited to any celebration of your service to our country because you have been an extraordinary—you have been a wonderful man to work with. We have trusted you implicitly. We get straight answers. We think you have been extraordinarily competent, and you've made a difference in government. We all salute you for that, and I am going to think of another hearing that I can get you to come to before you retire.

Mr. LIEBERMAN. I deeply appreciate that.

Mr. SHAYS. I am going to have Mr. Schrock take the chair, and you may have some questions.

I thank Mr. Kucinich for suggesting we have another hearing; and what I would like to do is, I would like to, you know, put the

administration on record that we will have another hearing before the end of the year, just to see how we're doing, because I do think that the incentives that Mr. Tierney is really wrestling with—I mean, one of them is just, you know, the cost and accountability, how you're doing.

I thank all of our witnesses for being here, and we'll continue with Mr. Schrock. Thank you.

Mr. SCHROCK [presiding]. Before I turn to my colleagues on the right, I'm sorry I'm late. Believe it or not, I was watching this in snippets as I was on my way up from Virginia Beach. Don't ask me how, but I was.

This is not a new problem. I worked in the five-sided building across the river for several years when I was in active duty as a Naval officer, and these are the same discussions we had then.

I think the thing that makes me happy is that this Secretary of Defense and this administration realizes—I can't believe that Ms. Jonas is the first-ever Deputy Under Secretary of Defense for Financial Management. You would think that was something that we would have had in place a long time ago in the Pentagon.

And Mr. Spinney said it best when he said, everything is done for political reasons. Man, you hit the nail straight on the head on that one, and it all rests right up here. And that mentality has got to change as well, and I think that's why we have the situation we have over there.

And Mr. Lieberman said, we have got to hold the Department's feet to the fire. That's not a bad idea either.

But we've all got to work together on this thing, because it's not going to get better if we just have these hearings and nothing substantive comes out of it.

So I appreciate your sitting here putting up—taking the barbs that we hand you all, but we've got to be partners in this thing as well.

Mr. Kucinich.

Mr. KUCINICH. I thank the Chair.

In Mr. Lieberman's comments earlier, he was theorizing that our present Secretary of Defense is going to be taking us on some new—in some new directions that would help resolve these longstanding problems. And, you know, we can all hope for that.

If you read the GAO report on Department of Defense financial management, in the category, Mr. Kutz, where you speak of longstanding financial management problems and items of reform, you state, over the last 12 years the Department has had several broad-based initiatives. You speak of the defense reform initiative, which in your reports did not meet the expected timeframes and goals: the Defense Business Operations Fund which, according to your report, inherited their predecessor's operational and financial reporting problems with respect to the working capital funds, and the Corporate Information Management program, which was expected to save billions of dollars by streamlining operations. And you cite that by 1997—you said that the benefits of this were not widely achieved after 8 years of effort, spending $20 billion, and that eventually this initiative was abandoned.

Now, I might ask you, sir, do you see any cultural problems with the Department of Defense here that might work against this administration?

Mr. KUTZ. Absolutely, I believe that's probably the No. 1 nut to crack here with respect to resolving these issues.

I don't know if Ms. Jonas or Mr. Lanzillotta would have testified to that here, but I think there's a lot of battles that go on inside the Pentagon about issues such as funding for technology investment or putting in place basic internal controls over various programs.

Just something as simple as—and I testified before Chairman Horn several times. Their credit card programs over there, which there's nothing wrong with the actual systems there. That's a matter of people and internal controls; people simply aren't following good controls in many cases that are in place. We're paying monthly credit card bills with nobody actually reviewing the bill, so we find ourselves paying for things that the government shouldn't be paying for.

So, yeah, culture would seem to be the hardest issue to deal with here. I think there's a lot of people that probably are trying to wait this out and hope that this too will pass, and that's true in many departments in the Federal Government, and it's just going to take a lot of effort by the leadership to——

Mr. KUCINICH. How do you change an institutional culture that spends money, that has a blank check basically, that is getting less and less for its dollar, and that is spread out all around the United States by virtue of a contracting program that is quite political; and my guess is, through campaign fund-raising, probably has an element that helps to ground it in the institution as well? What's your idea on that? I mean, you've obviously thought about it. What would you do if you were king? Of course, we don't have those things, but if you were, what would you do?

Mr. KUTZ. I would suggest one of the things earlier that you should do is have periodic hearings on this subcommittee and make it clear to the Department that you mean business with respect to this and that you're not going to go away. That certainly is one thing.

What Mr. Hite and I talked about earlier with respect to the business systems here, the Congress having better control and better transparency with respect to how that money is being spent is another action. Again, it's the oversight in some cases; you know, hearings like the ones we've had on the credit cards that have gotten a lot of attention. That gets the Department's attention. Money, oversight and certainly negative publicity get their attention.

Mr. KUCINICH. Well, you know, Mr. Spinney, you made some of the same points you're making today when you testified in front of Congress in 1983; is that correct?

Mr. SPINNEY. Yes, sir.

Mr. KUCINICH. And what was the response of the Defense Department officials at your insistence that the Pentagon work immediately to clean up its books?

Mr. SPINNEY. Basically my criticism was dismissed because it was historical, like the F–18 analysis that I showed; and the argument was made that we have reforms in place that will change this

thing. And at that time they were referring to what were known as the Carlucci initiatives, which I'm sure Bob Lieberman remembers, which have—you know, are in the dust bin of history now. And the specific quote made by David Chu at the time, who was my boss's boss's boss, was that "I urge patience."

Mr. KUCINICH. Well, you know, to quote that great philosopher Yogi Berra, "It's deja vu all over again." You know, we've got, 20 years ago, the Pentagon urging patience, the Comptroller's office urging the same thing today.

Final question, has the Pentagon, in your estimation—I just want to put this on the record—has the Pentagon's financial management practice worsened or improved in the past, patient 20 years?

Mr. SPINNEY. I can't speak to the question of the disbursements which have been adequately covered by the other witnesses—in both panels, for that matter. I can speak from the perspective of the PPBS, which is something I've examined in detail since the 1970's. And, again, I want to emphasize, this is the top-level financial management information system in the Pentagon, and I can say without reservation that it is far worse today than it's ever been.

Mr. KUCINICH. Well, we can end on that, but also if it's a new beginning, as we hope for, according to some of the testimony here——

Mr. SPINNEY. May I make one elaboration on that, though?

Mr. KUCINICH. Sure.

Mr. SPINNEY. It's important to understand this administration has inherited this problem. I think it's really important to understand that we basically squandered a decade in the 1990's. The end of the cold war gave us an opportunity to put our house in order, and we had 20 years to do it, because the baby boomers start hitting the old folk's homes around 2010. We blew the first 10. We're out of time; we've got to move out now.

Mr. KUCINICH. Yeah. And I would say that any of the discussion that this committee has had today, that I've noticed was not trying to say, well, you know, this is in the lap of this administration; except that, you know, we have an administration which is in charge, and they're challenged to do something about it. The failure of the previous administration to do something about it is no excuse, and the failure of the administration and administrations previous to that, no excuse.

There's a point at which the American taxpayers have to ask, what kind of national defense am I getting for the money which I'm paying in my taxes?

You know, it's interesting—Mr. Chairman, you know, all of us on occasion will hear from one of our constituents who gets audited by the IRS, and, I mean, think about this now. One single taxpayer gets audited by the IRS; and the IRS has a lot of good auditors, and they will sharpen that pencil and they will take a look at the return and they will go over it line by line, and you know what? If there's an extra penny to get out of it, they will find it. I have no question about it.

And the cartoons of years ago of a Joe Taxpayer walking around in a barrel—you know, there are people who feel some sympathy

with that condition, and yet on one hand, while the taxpayers of this country will get reamed if they misstate their taxes by even a fraction, look at this, $2.3 trillion. They can't even keep track of it.

Why is it that the Department of Defense is not subject to the same type of scrutiny, thank you, that the average taxpayer would be subject to by our own government?

I mean, it's clear here that we have a system which is in need of both quantitative and qualitative transformation, and we're looking at perhaps a new structure at some point, you know, promoting the—or to provide for the common defense is a foundation of this country, and the people of this country have a right to expect that the country will be defended, but our accounting is indefensible.

Mr. SCHROCK. Let me—and Mr. Kucinich, let me make a comment on that.

You know, at the Pentagon, when I worked there, it was—if a Colonel Spinney said something, well, if you don't like it, wait long enough, he'll get transferred and he's out of there. And that's been the mentality: They're going to go away eventually, and then the hierarchy that's there all the time will just continue to do business as usual. That is the problem, and I really believe that Donald Rumsfeld came there to transform that.

He got sidetracked on September 11th, but I think he's going to get back on that track again. And if there's ever a Secretary of Defense in history who has the ability to do it and do it successfully, it's Donald Rumsfeld; and I think he will. And we need to support him as much as we possibly can, because that mentality was there when I was there as a lieutenant, and it's there when I'm a Congressman. I never could have guessed that would be the case, but it is.

Do you have anything else?

Mr. KUCINICH. I want to thank the Chair for the opportunity to ask these questions, and I want to thank all of the witnesses for lending their experience with this system to this committee. Thank you.

Mr. SCHROCK. Thank you. And I guess if there are no more questions, let me thank you all for coming too. We do need to invite you back more often. We need to hear these stories over and over and over again, until these things get resolved; and I, for one—I wish they'd have this on a Wednesday. Members travel back here on Tuesday, so it's kind of hard to get everybody here, but I think every Member needs to be here to hear what you all have said, and maybe next time we can do it on a Wednesday when they're here again.

Thank you very much for being here and sharing with us, and that's it. The committee will rise.

[Whereupon, at 1:09 p.m., the subcommittee was adjourned.]

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